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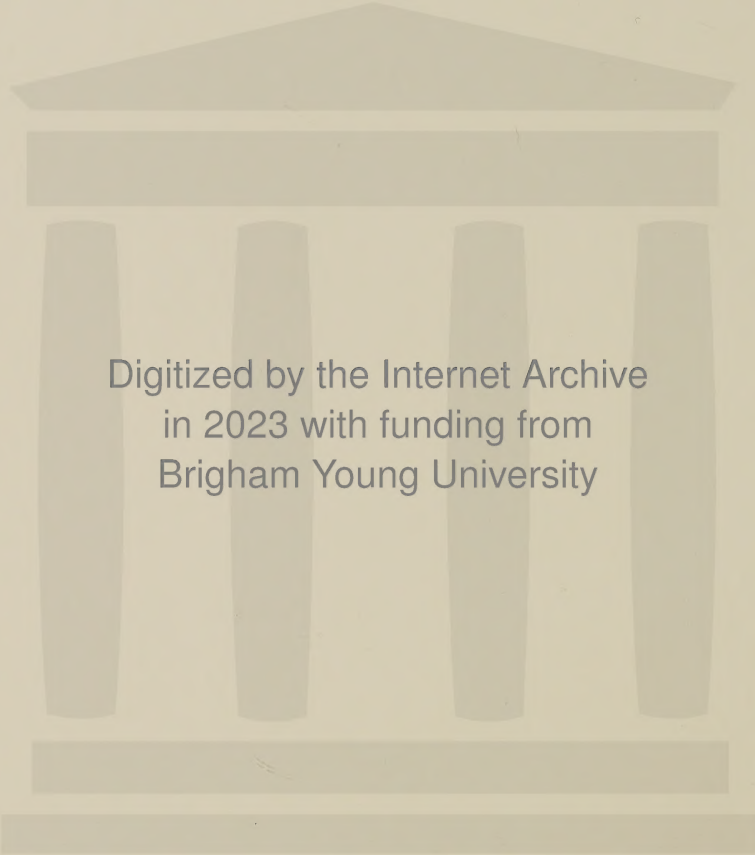
# **The International Monetary System and its Reform**

**Part III**

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# THE INTERNATIONAL MONETARY SYSTEM AND ITS REFORM

## Part III

# CONTRIBUTIONS TO ECONOMIC ANALYSIS

162

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# THE INTERNATIONAL MONETARY SYSTEM AND ITS REFORM

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United Nations project directed by Sidney Dell  
1979-1986

Published in cooperation with the United Nations

PART III



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## THE ROLE OF THE IMF IN THE 1980s

Ariel Buira\*

I. The role of the Fund

1. Through its activities the Fund may be considered as a provider of public goods to the international economy in the fields of surveillance of exchange markets, of a liberal trade and payments system and as a provider of finance and promoter of adjustment. Increasingly, the Fund has taken a major role in providing the international financial community with the certainty that the adjustment programme adopted by a member country is a sound one. This gives confidence that existing imbalances will be solved through the implementation of appropriate policies. In so doing, the Fund provides the member country with invaluable assistance in securing additional external credit and when appropriate, in the renegotiation of its external debt and the avoidance of a net drain of resources, so as to facilitate an orderly adjustment process. The adoption of a Fund programme restores a degree of confidence to the international financial community. This role takes on added importance in view of the emergence of debt problems in numerous countries and the danger that the situation of many others could deteriorate rapidly as their access to capital markets is reduced. These countries may turn to the Fund for assistance; indeed some of them have already done so recently and others are likely to do so in the future.

2. There can be little disagreement with the notion that the Fund must adapt its policies to the changing needs of its members and of the international adjustment process. This should not be seen as a new departure, since in 1974 the emergence of unprecedented pressures on international payments led the Fund to the establishment of the Oil Facility, and more recently, to the setting up of the Supplementary Financing Facility and to the policy of enlarged access.

3. The major problems to be addressed by the Fund in the coming years are (a) the role it should play in the event of emergency situations that could develop in international capital markets and (b) its role in the adjustment of structural payments imbalances of numerous countries in the context of a more or less stagnant world economy.

(a) Emergency situations

4. Looking at the international capital markets, the present danger is that the cut-back in capital flows to developing countries may be so

\*January 1983.

sharp in the coming months that it will not only prevent orderly positive adjustment, but also prove destabilizing - initially to the countries - and soon after to the banks suffering loan losses that would impair their capital base. Orderly adjustment by deficit countries requires certain levels of external capital flows and a certain time period. The present danger is that capital flows may diminish rapidly or be reversed and therefore, that the financial resources made available, and the time span allowed to countries, may be cut back to levels that will not be consistent with the minimum required for an orderly adjustment. If so, the risks that are apparent in the international financial system could materialize. Countries forced to adjust abruptly, facing negative rates of economic activity and falling incomes may not be able to sacrifice imports to the extent required to service their external debt. Default by one or several large borrowers could force banks to write off some of their assets, undermining the confidence on which credit institutions must rely to survive.

5. In the short run, the issue is to ensure that financial flows to countries with serious debt or liquidity problems continue at an appropriate rate so as to avoid a liquidity crisis that could force these countries to suspend debt payments and to allow them to undertake an orderly adjustment process that does not place unbearable strains on their economic and social framework. This has been traditionally one of the roles of the Fund. In addition, in the event of a crisis, the Fund can act as a lender of last resort in the international monetary system by providing assurance that resources can be mobilized on a large scale in the event of a threat to the stability and functioning of the system. However, Fund resources at present levels are clearly insufficient to allow it to play this role to the extent required. The need was recognized at the time of the establishment of the GAB in 1962; however, it is apparent that GAB should be expanded with regard to (i) country coverage, since GAB can at present only be used in support of members of the GAB, and (ii) the amount of resources available, which at SDR 6.4 billion must appear inadequate to meet present needs.

6. As we shall see below, the Fund must increase its resources, ideally through a substantial increase in quotas. However this is too lengthy a process to enable it to meet the needs of the next two years. In the short run, Fund resources must be supplemented by borrowing from official sources and/or commercial banks to ensure that they are sufficient to meet the requirements of its members and to preserve the stability of the international financial system.

7. The recent experience of countries which have faced a liquidity crisis, and resorted to the BIS, shows that when rapid financial support is needed the Fund cannot provide it under existing policies. However, since BIS support is often conditional on a Fund-supported adjustment programme, the question comes to mind whether the Fund should not itself provide such support. This could be done either from its own resources or through drawings from arrangements such as the GAB, which would enable countries faced with a sudden cut-off in external credits to avert a liquidity crisis.



8. At present there does not exist a mechanism that will provide countries and banks with the assurance that a credit cut-off or speculative capital movements may be, at least partially, compensated, and that resources will be made available in sufficient amounts to avert a crisis and permit an orderly adjustment programme to be designed and implemented.

9. Since there is no certainty that the BIS will in future assist non-BIS countries, an increased capacity of the Fund to deal with emergency situations at short notice would appear necessary. The United States proposal, raised in Toronto last September, of an emergency fund administered by the IMF would seem to be a recognition of this need.

10. In addition to increasing its resources, the Fund would have to modify its policies on drawings to permit large drawings to be made at very short notice. The need to establish a new facility, which had been informally considered in the past in connection with problems caused by capital flight, should be recognized in the light of current problems. Access to this facility would be limited to those countries facing a liquidity crisis as a result of capital outflows or of a very sharp decline in access to external credit. In such cases, if the Fund were not satisfied that the stance of the country's current economic policies was in broad terms appropriate, it would require a policy statement by the authorities similar to that required at present for first credit tranche drawings. Countries wishing to draw from the Fund under this facility would have to undertake to repay the full amount drawn over a twelve-month period or enter into an upper tranche adjustment programme with the Fund.

(b) Medium-term adjustment and financing

11. While it is unlikely that major commercial banks will altogether cut off credit to major debtors in view of the risks that this would entail for the banks themselves, they are likely to require larger spreads and higher fees to compensate for the increased risks of these lending operations, offsetting in part the benefits that follow from the recent limited decline in interest rates. However, the problem for smaller debtors may be more difficult since they lack the leverage of the larger borrowers. Smaller banks, on the other hand, will in many cases wish to reduce their international exposure and limit international lending operations. Therefore, the likely outcome is a prolonged and significant decline in overall credit flows to developing countries, with a possible sharper decline in flows to small developing countries facing severe debt and payments difficulties. This decline is not likely to be compensated by increased flows from other sources, since most industrial countries are faced with difficult economic and/or budgetary positions. Moreover, the decline in OPEC's surpluses will also mean diminished aid and financial flows from that source. In addition, private investment flows are unlikely to increase in view of depressed world activity, existing excess capacity and the heightened perception of risk associated with such investment.

12. The problems of development financing and balance-of-payments support do not appear capable of market solution in the short term; therefore official institutions should play a larger role. The best alternative to financing is, of course, to expand developing country exports. However, in view of the depressed state of the world economy and of the protectionist trends at large, the prospects for these do not appear to be favourable at present.

13. We have seen that while the structural nature of the adjustment programme faced by many developing countries today calls for larger amounts of longer-term finance, the trend is for the markets to reduce overall flows, shorten maturities and demand higher spreads as a means of limiting the risks associated with international lending operations. A similar trend toward shorter programmes with smaller amounts of resources became apparent in the Fund during 1982. This conjunction of factors would suggest the need for increased Fund resources and greater emphasis on structural adjustment programmes with larger amounts of financing and longer maturities than at present. A greater role for the IBRD and other development finance institutions should also be envisaged.

## II. The size of the Fund

14. The problems faced by financial markets and by countries that have had heavy reliance on them suggest that in the future the Fund should play a larger role than in the past in the process of financial intermediation between surplus and deficit countries. This would serve the purpose of encouraging adjustment at an early stage of countries' imbalances through appropriate conditionality, thus preventing the emergence of intractable problems. In the words of Article I, Section (v) of the Articles of Agreement, the Fund would "give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct adjustments in their balance of payments without resorting to measures destructive of national or international prosperity". (emphasis added)

15. The emergence of problems in the international capital markets and the increased importance of structural problems suggest that the Fund should stand ready to finance a larger part of members' payments imbalances. This would be required to sustain total financial flows at appropriate levels both through the use of Fund resources and by enhancing the confidence of markets in the soundness of the adjustment programmes being followed by members.

16. For this larger role, the Fund would require substantially greater resources than it has at present, as well as some changes in its policy mix. The size of the Fund can be put in perspective by relating it to the tasks to be undertaken. Its ability to perform these tasks can be approached by comparing its size with payments imbalances, international reserves and the size of the international economy.

17. Since a major function of the Fund is to provide temporary balance-of-payments financing, the magnitude of external deficits is an important parameter. In 1980 the current-account imbalances of 111 countries for which data are available since 1962 was SDR 122 billion, 11 times the average for the period 1962-1965. In 1980 the size of the Fund was fourfold the average for the period 1962-1965 and consequently fell far behind the increase in imbalances. Over this period the ratio of the average size of the Fund to the average sum of current-account imbalances fell by almost one half, and the ratio of the size of the Fund to the average sum of overall balances by almost three-fifths. This shows the declining ability of the Fund to provide balance-of-payments financing to members.

18. In relation to international reserves, the size of the Fund is also lagging far behind. While international reserves and international bank lending have risen some 6 or 7 times from 1970 to 1980-1981 the size of the Fund has increased only 3 to three and a half times over the same period; while quotas over the same period barely more than doubled. Consequently, the contribution of the Fund to total reserves declined severely. The ratio of Fund-related assets to total non-gold reserves diminished from 19 per cent in 1970 to 9 per cent a decade later.

19. The size of the Fund has also fallen in relation to calculated quotas. The ratio of actual to calculated quotas fell in consecutive General Reviews from the 4th to the 7th (1965-1978), reaching in 1976 one-half of the value it had in 1965. Quota resources have increased more slowly than the Fund's capacity to provide finance to members, growing roughly sixfold from 1970 to 1980, while world imports and non-gold reserves expanded by factors of 12 and 15 respectively. While the size of the Fund advanced rapidly from 1978 onward and both quotas and the overall size doubled from the end of 1977 to the end of 1980, a period in which two General Quota increases became effective, these developments only restored the relative capacity of the Fund to about its 1976 level, a level far below that of any earlier period in the Fund's history.

20. The lagging behind of the Fund's resources has meant that financing needs of countries with payments deficits have increasingly exceeded the capacity of the Fund to provide appropriate assistance from quota resources within the regular tranche structure. This has limited the Fund's ability to promote adjustment through the provision of financial support in the context of a financial programme, or to provide an amount of resources which is significant to countries faced with a financial crisis. This is unfortunate, since the Fund's support, which is not affected by changes in the creditworthiness of the country concerned, has a stability which commercial bank credits often lack, and at times is the only support available to countries.

21. In looking to the future, it must be noted that the General Review of Quotas must serve the international community through the second half of the present decade. However, since the new quotas may not become effective until 1984, the expanded role required of the Fund may



necessitate its resort to borrowing as a temporary expedient to increase its resources.

22. Based on the projections published by the World Bank in its 1981 World Development Report, the average annual rate of increase in the SDR value of imports from 1980 to 1985 are 11 per cent and 13 per cent under the low and high growth assumptions respectively, and from 1985 to 1990 the corresponding figures are 10 and 12 per cent compared with 17 per cent observed over the period from 1975 to 1980.

23. Averaging the low growth and the high growth projections and based on historical ratios of Fund size to world imports of 3.9 per cent, which prevailed in 1971-1980. and of 5.3 per cent, the average ratio prevailing in the period 1961-1970, the Fund should have a size of SDR 101 to 138 billion, say of SDR 120 billion in 1985, and of SDR 168 to 228 billion, say of SDR 200 billion in 1990.

24. Despite their magnitude, these figures must be seen as conservative, since they do not take into account the larger role that the Fund will be called upon to play as a financial intermediary, nor the greater demands on its resources that may be expected as a result of the increased frequency and magnitude of structural imbalances in the difficult conditions of the current decade.

25. The appropriate size of the Fund (SDR 120 billion in 1985, and SDR 200 billion in 1990) could be obtained through a combination of increased quotas, SDR allocations and Fund borrowing arrangements. To the extent that quota increases are accompanied by SDR allocations, quotas could be smaller to achieve a given size of the Fund; larger SDR allocations would mean that smaller quotas would suffice to increase the size of the Fund to a postulated level.

26. Increased quotas may be regarded as equivalent to an extension of borrowing arrangements with all member countries, which may be resorted to when the member in question is in a sufficiently strong balance-of-payments and reserve position. Quota increases have the advantage of flexibility and in general are to be preferred to borrowing, since they are in keeping with the co-operative nature of this intergovernmental institution. Borrowing, on the other hand, may be seen as a bridging arrangement to cover a resource gap prior to the adjustment of quotas, since borrowing agreements can be concluded more rapidly than quota reviews. Allocations of SDRs also have the advantage of permitting a rapid increase of members' reserves when these are felt to be warranted under the provisions of Article XVIII and would preserve a balance between the provision of conditional and unconditional liquidity. Moreover, allocations would serve the objective of making the SDR the principal reserve asset of the international monetary system which calls for an increasing supply of SDRs. The present distribution of reserves and the depressed condition of the world economy suggest the convenience of combining a very substantial increase in quotas with a significant SDR allocation as a means of strengthening the reserve

position of member countries at a time of large payments imbalances and depressed world economic activity.

### III. Fund policies in the 1980s

27. In response to the economic conditions prevailing in the 1980s, the Fund would also have to revise its approach of seeking to restore an external balance essentially through demand management policies and to give greater emphasis to the correction of structural imbalances when these are significant. Supporting structural adjustments will often require substantial investment programmes in key sectors; these should be encouraged and supported to the greatest extent possible, even when they may result initially in a higher fiscal deficit or a weakening trade account in the short run, since they will lead to a stronger balance-of-payments and budgetary situation in the medium term. Structural adjustments would permit the achievement of a more viable external position as well as higher rates of growth for the countries concerned both during the life of the adjustment programme and in the medium term, with the consequent benefits to those countries and to the international community.

28. A major policy adjustment required from the Fund would be that of equating the duration of the adjustment programme to the requirements of the country; that is to say, to make the length and the characteristics of the adjustment programme a variable and not a parameter for economic policy. The current structure of conditionality is centred on the need to ensure the revolving character of Fund resources; this need cannot be questioned. What may be questioned is the speed and modalities with which adjustments are expected to take place. The Fund's current practice with regard to repayment of drawings and therefore with regard to the duration of adjustment programmes was established in the 1950s when the duration of business cycles then prevailing was 5 to 6 years. Today, this is no longer the case and the 3 to 5 years repayment period required on most Fund drawings is often inappropriate. A lengthening of repayment periods to 8 to 10 years as allowed under the EFF would be called for.<sup>1/</sup> This would call for changes in the liabilities of the Fund, whether through longer-term loans or higher quotas.

29. In the existing institutional framework, structural adjustment programmes can also be assisted by the IBRD and other development finance institutions. These have an advantage over the Fund in having greater expertise in the design and implementation of investment programmes. Moreover, their loans have much longer maturities and therefore do not place a burden on the balance of payments or the debt

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<sup>1/</sup>At present most drawings are made under stand-by arrangements and subject to a 3 to 5 year repayment period; the effective repayment period of EFF drawings is, in fact, not much longer since frequently most of the resources made available under Fund drawings are borrowed resources and must be repaid in 4 to 7 years.



service of the borrowing countries. Indeed, Bank loans can frequently be repaid from the increased productive capacity associated with the investment which they finance. This increase in production often benefits the balance of payments through increased export capabilities and strengthens the creditworthiness of the countries concerned.

30. In the longer run the existence of structural adjustment and the nature of programmes required for their correction should lead to questions regarding the proper role of the existing international institutions. It is apparent that the Fund as it presently exists is best suited to deal with certain types of imbalance, i.e., those associated with problems of excess demand which are often the result of large budgetary deficits. But it is less well adapted for dealing with structural imbalances. On the other hand, the Bank is suited for addressing such imbalances as require changes in the structure of the economy.

31. Current payments problems are frequently a mixture of both types of imbalances. In these circumstances, assistance by two separate institutions having separate management, as well as their own somewhat different policies and functions is not necessarily the best institutional arrangement, even when co-operation between both institutions is generally good. The problem of structural adjustment is one that in most developing countries cannot be dissociated from that of development, and there is a risk that a very specialized institution will have a partial vision of the problem and follow a less than comprehensive approach to its solution. At present, the Fund can play an important role in averting a liquidity or financial crisis, thus preserving solvency in the country concerned and the stability of the international financial system. But its traditional approach does not often assist structural adjustment or the maintenance of activity at appropriate levels. The Bank, on the other hand, is not in a position to move with the necessary speed to come to the aid of countries in serious financial difficulties.

32. The nature and magnitude of the current crisis would seem to call for greater integration of both approaches; therefore the re-examination of the role of existing financial institutions in the light of present needs would seem desirable. In the meantime, the resources of both institutions would have to be enlarged significantly to compensate for the decline in flows from capital markets. But no matter how substantial an increase in resources may be obtained, it will still be necessary for the commercial banks to continue to play an important role. Fund resources should be seen as complementary and supportive of financial flows on commercial terms rather than competitive with them.

33. Since the banks have a strong interest in the preservation of the solvency of their debtors and a commercial interest in continuing to do business with them over the coming decades, they should be encouraged to join with international financial institutions in providing the necessary flows for the financial recovery and further continued development of debtor countries. This should be done taking great care

not to give rise, or even appearing to give rise, to the centralization of decision-making with regard to availability and amounts of credit available to individual countries.



# THE IMF'S WORLD ECONOMIC OUTLOOK; A CRITIQUE

David Worswick\*

## Introduction

1. Since the early 1970s the staff of the International Monetary Fund have prepared studies of the world economic outlook and these have been published annually since 1980. This paper is a critique of the analysis of world economic prospects and policies as presented in World Economic Outlook for 1981 and 1982.

2. World Economic Outlook surveys contain firstly accounts of economic developments in recent years in industrial and developing countries. These accounts are supported by a large number of statistical tables. Secondly, there are short-term forecasts for the world economy for 1982 and, in some instances, for 1983 as well. These short-term forecasts lead into Medium Term Scenarios for real output and inflation in the industrial countries. Three scenarios are presented on the basis of different assumptions about economic policy. In the two surveys there is an analysis of the nature of "stagflation", i.e., the coexistence of high inflation, high unemployment and slower growth of productivity and in "Key Issues of Policy" there is a thorough discussion of the best policies for countries, both developed and developing, to pursue.

3. In the 1982 survey World Economic Outlook concludes that: "to restore a basis for sustained economic growth, it is crucial for national authorities to maintain the broad thrust of their present policy strategies while adapting them to enhance their effectiveness". The greater part of this critique is devoted to a discussion of this conclusion and of the evidence which is brought in support of it. The paper begins with an examination of the basis of the three alternative medium-term scenarios. It then turns to the question of whether the reduction of inflation is both a necessary and a sufficient condition for sustained growth. There follows an extended discussion of the causes of the present stagflation and a consideration of possible alternative strategies besides that which is espoused in World Economic Outlook. The final section of the paper is devoted to the likely impact of alternative strategies of the industrial countries upon the developing countries.

4. The Preface to the surveys by the Managing Director of the Fund makes it plain that the report is "issued in the name of the Fund's staff, and does not necessarily represent the views of the Executive

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Board". At the same time he points out that these studies have grown in depth and comprehensiveness and "have become an integral part of the work of the Fund". In this paper the surveys are referred to simply as Outlook, adding 1981 or 1982 where the analysis being discussed is most fully developed in one or the other.

5. The Outlook surveys draw on specialized contributions from the five Area Departments and several functional Departments of the Fund, and the whole work was co-ordinated by the Research Department. The author of this paper had the opportunity to meet informally members of the Fund staff, and he is grateful to them for their courtesies and their patience in answering questions. None of the Fund staff members is in any way responsible for anything written in this paper.

## II. Outlook's Analysis

### The Medium Term scenarios

6. Outlook presents three alternative scenarios that could emerge in the medium term from alternative policy courses in industrial countries. Scenario A is called "central" and is based on the assumption that "industrial countries affected by inflation persist with policies of monetary restraint aimed at reducing this inflation by restricting the growth of nominal demand. Monetary restraint is presumed to be reinforced by compatible and supportive fiscal policies and by a certain effort to deal effectively with structural rigidities in labour and goods markets". These latter qualifications make scenario A seem more optimistic than would be implied by the concept of "unchanged policies" or "continuation of present policies" which is sometimes used in medium-term assessments.

7. Scenario B is more pessimistic on the basis that authorities "fail to implement coherent policy courses to deal with problems of inflation and structural adjustment". Such failures could arise from the relaxation of monetary restraint in the face of rising unemployment or from an inability to develop fiscal policies and policies affecting the supply side that are consistent with restrictive monetary policies.

8. By contrast, for the optimistic scenario C, it is assumed that "major measures" are taken to deal with rigidities in labour and goods markets. Also there is supposed to be a gain in "credibility" of the authorities. The outcome is a more rapid reduction in inflationary expectations, accompanied by greater saving and investment.

9. The main features of these three scenarios are presented in statistical tables. The figures for 1982 and 1983 are essentially Outlook's short-term forecast made in the middle of 1982 and are on a year-on-year basis. The differences between the scenarios refer to the years 1984-1986. In the case of real GNP growth the figures are in

terms of average annual rates, and for all the industrial countries they can be summed up as  $3.2 \pm 1$  per cent. For inflation, as measured by the GNP deflator, the alternatives are not so easily summarized. In scenario C the inflation rate falls from 5 per cent in 1984 (i.e., 1984 over 1983) to 4 - 4.5 per cent in 1986, whereas in scenario B it rises from 7 per cent to 8.5 per cent. The central scenario has a slight decline from 6 per cent in 1984 to 5 - 5.5 per cent in 1986.

10. In preparing these scenarios Outlook did not use a formal econometric model whose parameters were estimated from past experience or were imposed. This is not to make any claim for the intrinsic superiority of such models over less formal procedures in which experienced economists carry a framework of the economy "in their heads", which is our understanding of how the Outlook figures were generated. Nevertheless, one technical advantage of the former is that simulations of alternative assumptions about specific variables are easily carried out, a process which is very laborious for less formal methods.<sup>1/</sup>

11. Medium-term projections for whole economies are difficult to make and anyone familiar with their construction is aware of the very large margins of error involved. There is also a dilemma of presentation. In short-term forecasts dynamics are very important: Is recovery now under way? Will investment fall off next year? And so on. But in medium-term projections one is mainly interested in trends. If one presents the medium-term future as linear (or long-linear) it is promptly objected that this is unrealistic. On the other hand, if one attempts to produce a dynamic path, showing fluctuations between years 3 and 4, for instance, it is objected that such outright prediction is impossible. On the face of it, Outlook's method of providing a common short-term projection for 1982 and 1983 and pinning alternative scenarios on to the end of it, seems a sensible compromise. Policies designed to reduce "rigidities" are unlikely to have much effect in the first year or two. Even so, this method may leave some rough edges. For example, in scenario C inflation falls from 7.6 per cent in 1982 to 4 - 4.5 per cent in 1986, a decline of around 3.5 per cent per annum in four years. But more than half of this reduction appears to take place in a sharp step down between 1983 and 1984. There is, one would suspect, no economic reason for this: it is just an awkward accident of the particular form of presentation.

12. The fact remains that the short and medium terms do not follow one another in a non-overlapping sequence but, on the contrary, both start at the same point of time, namely, now. This leads to a substantial objection concerning scenario B, which we will discuss in a moment. But before doing that let us get some idea of the significance of the figures which emerge by comparing them with the figures for the recent past and with another medium-term scenario.

13. The GNP growth rates of scenario A for the seven leading industrial countries are about the same as the average for those countries between 1970 and 1980. Scenario A leads to unemployment in 1986 a little less

than in 1982 and this seems to imply a growth of labour productivity a bit slower than in the 1970s, a rate which was itself, of course, much reduced below that prevailing in the 1960s.

14. For all industrial countries the average GNP growth rate for 1982 and 1983 followed by scenario A for 1984-1986, comes to about 2.25 per cent, which compares with a projection of an average of 2.6 per cent for "all OECD countries" for the period 1982-1987 given in a recent NIESR projection.<sup>2/</sup> Similarly the inflation projections, albeit for slightly different periods with slightly different coverage, seem to be quite close. In other words, there is nothing startling about the actual numbers which emerge from scenario A: they are "in the same ball park" as other projections currently made on a fairly similar basis. The broad message is that a "central" projection in industrial countries, if current policies are continued, would be some gradual amelioration of inflation but with growth no faster than in the 1970s and with little prospect of any substantial fall in unemployment below present levels.

15. Let us, therefore, turn to more substantial questions. One theme, constantly repeated, runs throughout Outlook. Only if inflation is reduced and inflationary expectations are dampened will sustained recovery of output growth become possible. It is not, however, stated how far the inflation rate must fall (to zero?) nor whether inflationary expectations must be extinguished forever, or may be expected to revive once recovery gets under way and unemployment starts steadily falling. Scenario A is clearly regarded by Outlook as feasible but in it the average inflation rate in 1986 is still over 5 per cent. This is a figure which would certainly have been considered "too high" in many countries in the 1960s. Should we expect to be told once more in 1986 that restrictive policies must still be maintained in order to bring inflation still further down? Again, if by any chance economies did better, output-wise though not inflation-wise, than the Outlook projection, entailing, of course, higher nominal aggregate demand than Outlook envisages, would it then advocate even tighter monetary policy? Such questions are not discussed.

16. It is acknowledged that relaxation, whether of monetary or fiscal policies, or both, can bring about immediate gains in output and employment, but only at the cost of higher inflation and slower growth in the longer run. Given all the uncertainties of long-run projections it would be of interest to know just how big such short-term gains might be and how long they could last before they are first reduced and then overtaken by the dire long-term consequences. From this point of view the presentation of scenario B is one-sided. We are shown the consequences of premature relaxation but all traces of the output-increasing and unemployment-reducing spree which incur this penalty have been obliterated. The conjunction in Table 43 of the short-term forecasts in 1982 and 1983 with the medium-term scenarios thus turns out to be misleading. Given that by now (December 1982) the output figures for 1982 and 1983 will almost certainly be revised down when a new exercise is undertaken, it would seem to be wiser to regard the figures of the last three columns of the table simply as quantitative illustrations of the ideas of Outlook concerning the



medium-term consequences of different policies but not to attempt to embed them in any realistic sketch of the future. It should also be stressed that these scenarios are illustrations of Outlook's ideas. They do not embody statistical evidence in support of those ideas. This contention will be more fully substantiated later on.

#### Inflation and Growth in Industrial Countries

17. In the model represented by the three scenarios there is an inverse association between the inflation rate and the growth rate, with the direction of causality running from lower inflation to higher growth. Twenty years ago many economists would have offered a model with a positive association between inflation and output (albeit its level instead of rate of change), or more precisely a negative association between inflation and unemployment, with the direction of causality running from unemployment to inflation. The contrast between the two models is a reminder of the cloud of uncertainty and confusion which has descended upon economic analysis and which undoubtedly reflects the uncertain and even paradoxical performance of actual economies in the past decade. In this new era of uncertainty special care needs to be taken to keep facts and values separate and to distinguish what is the case from what one hopes might be the case.

18. In the past ten or fifteen years a number of phenomena have been seen in most industrial economies which are in sharp contrast with earlier post-war experience. Of these, perhaps five stand out:

- (1) Higher inflation rates;
- (2) Higher unemployment rates;
- (3) Slower growth, not only of total output but also of productivity;
- (4) Growth of public expenditure;
- (5) The move from fixed to floating exchange rates.

19. Whether, and to what extent, these phenomena are interconnected are questions which are crucial for the determination of policy. There are probably very few economists who would deny that there was any link between any pair of the five factors enumerated. The ultimate differences in policy prescription are related to the various weights attached to the different possible links by different economists. Some may believe that higher inflation will ipso facto be strongly unfavourable to investment and growth; others that it is only changes in inflation which are harmful; while still others may believe that inflation does little harm to real output.

20. In the discussion of the key issues of policy Outlook 1982 reaches the conclusion that "to restore a basis for sustained economic growth it is crucial for national authorities to maintain the broad thrust of their present policy strategies, while adapting them to enhance their effectiveness". Outlook acknowledges that present policy strategies against inflation have been accompanied by a sharp decline in economic



growth and large increases in unemployment, and it goes on to observe that the social and economic costs of such a waste of human resources are huge and may well entail political risks. In this section I shall endeavour first of all to set out the line of reasoning which leads Outlook to its sombre conclusion. Then I shall attempt to test the strength of the different links in the chain of argument.

21. Fundamental to Outlook's argument is the belief that the reduction in inflation, and in inflationary expectations, is a necessary condition for sustained economic growth. Whether Outlook considers it to be also a sufficient condition is not clear, but it is enough for the line of argument that it should be a necessary condition. The way to bring down inflation is to secure a "reduction in the growth rates of aggregate nominal demand sufficiently marked and prolonged to break inflationary expectations" (Outlook 1981, p. 9, col. 1), which entails a corresponding limitation of monetary growth. Although the primary instrument for reducing inflation is monetary policy, fiscal policy is also important.

22. Large budget deficits, says Outlook, hinder monetary restraints, certainly when they are monetised, and even when they are not, if private market participants come to believe that they will be sooner or later. Deficits push up both interest rates and inflationary expectations. Large deficits may also "crowd out" private investment, thus reducing economic growth in the longer run. Behind large deficits there usually lies higher public expenditure. This higher expenditure could, in principle, be covered by taxation, but higher tax rates could mean the loss of efficiency in the long run and there are political costs (Outlook, 1982, p. 13). Outlook pays a lot of attention also to "rigidities" in the labour and goods markets. These rigidities include: downward inflexibility in nominal and real wage rates; social security systems which enable labour unions to resist wage cuts; price support systems for agricultural products; industrial subsidies and import duties. Removal of rigidities, however, is not a prerequisite of reducing inflation, which has already been taken care of by monetary restraint, but a means of securing higher output and employment in any given inflationary context.

23. Though not essential to their argument concerning the need to reduce inflation, it is of interest to know what Outlook thinks brought about excessive inflation in the first place. Outlook clearly acknowledges the impact of the rise in oil prices on costs in industrial countries, but it lays special stress on the role of increases in public expenditure and budget deficits in contributing to inflationary expectations.

24. Summing up its own analysis and policy prescription Outlook claims that there would "appear to be no satisfactory alternative to the comprehensive medium-term policy approaches outlined in 'Key Issues of Policy'", i.e., the adherence of national authorities to the "broad thrust of their present policy strategies".

Critique of Outlook's arguments

25. Whether inflation can be expected to increase or decrease investment, and thus productivity, depends on what kind of inflation it is. If costs are in any degree sticky, a rise in aggregate demand may lead to a rise in prices and output and a shift to profits, which encourages investment. On the other hand, if the pressure for the rise in prices comes, as it were, from below, from increases in import prices or from intensification of wage pressures, then profit margins may be squeezed and investment discouraged. It seems likely also that the response of the real economy to inflation and to changes in inflation will depend on the historical context. The impact of a given rise in nominal aggregate demand on the price and output levels may be different if it comes after a long period of price stability than after a long period in which prices have been rising. Economic theory provides no unambiguous presumption about the relation between inflation and growth of the kind which Outlook appears to assert, namely, that a reduction in inflation from present levels is a necessary condition for sustained economic growth.

26. But is there not evidence from actual experience to guide us? Outlook 1982 does provide some evidence concerning the link between growth and inflation, though only for a short period and only for non-oil developing countries. The data are drawn from 112 countries which are divided into two equal groups for any particular time period of "low inflation", and "high inflation" countries. Given this basic partitioning of the countries for any period, the average growth and inflation rates for the two sub-groups are calculated. Median rates are also calculated. In the period 1975-1981 the median inflation rates of the two groups were 8 and 19 per cent respectively, while the median growth rates were 4.7 and 4.2 per cent. Outlook also notes that the association between higher inflation and slower growth appeared to be getting stronger through the period. The existence of a statistical association does not, as Outlook correctly observes, tell us anything about causality. Nevertheless, it concludes that the strengthening of the association "does suggest that the opportunity costs associated with inflationary demand management policies have tended to increase as the world economic environment has become progressively less benign". The evidence certainly does not exclude this conclusion but since no evidence whatever is provided to associate the various rates of price increase with "demand management policies" it does not point to it either.

27. Outlook provides no comparable analysis for industrial countries. There is no time to undertake a major study but some evidence can be quickly assembled.

28. The Table shows the annual average rates of increase in real GDP and consumer prices in seven large industrial countries for the periods 1960-1970 and 1970-1980. It is taken from the National Institute Economic Review for November 1982 which comments as follows: "It is true that inflation is higher and the growth of output lower in the 1970s

than in the 1960s in every case but comparing the seven countries in the 1960s, higher inflation seems if anything to go with higher growth (although this association depends on the inclusion of Japan). In the 1970s a cross-country comparison gives no sign that higher inflation is associated with output growth - either higher or lower. Neither can it be said that an especially rapid acceleration in inflation between the two decades seems to be associated with a specially abrupt slowing down in the growth of output".

Table I

Growth and inflation, 1960-1970 and 1970-1980  
Average annual percentage rates of change

	United States	Canada	Japan	France	Fed. Rep. of Germany	Italy	United Kingdom
1960-1970							
Consumer prices	2.6	2.5	5.6	4.0	2.6	3.9	3.8
Real GDP	4.0	5.3	10.6	5.5	4.7	5.7	2.8
1970-1980							
Consumer prices	7.8	8.0	9.0	9.6	5.1	13.9	13.7
Real GDP	3.0	4.0	4.9	3.6	2.8	3.1	1.9

Source: OECD, Main Economic Indicators and Historical Statistics.

29. Similar evidence concerning the relation between inflation and growth across a number of countries was given by Thirlwall, A.P. and Barton, C.A. in a paper in the Banca Nazionale del Lavoro Quarterly Review, September 1971. It dealt with 51 countries in the period 1958-1967. Their main finding was that for the seventeen countries with per capita incomes of more than \$800 which experienced rates of inflation varying from 3 to 8 per cent, there was a significantly positive association between inflation and growth; for the 34 remaining poorer countries as a whole there was no significant relation, but if one selects from them those with inflation rates higher than 10 per cent, the seven countries in question show a negative association. The general conclusion for this period was that inflation at rates up to about 10 per cent seems to have stimulated growth, higher rates possibly to have inhibited it.

30. Finally, it is worth a mention that the period from 1960 to 1973 was one which, by any previous peacetime standards, was one of quite rapid inflation. Output and productivity in all of the main countries grew faster than in any previous period of comparable length. In the United Kingdom the rate of productivity growth was nearly three times as great as in 1870-1890, and in Germany and France the 1960-1973 rates were nearly twice as great as those from 1929 to 1938, which in turn were better than those before the First World War.



31. This evidence is enough to cast doubt on any claims concerning an association between high inflation rates and low growth rates. Outlook may believe that lowering inflation will promote growth but that is all there is to it. There is no empirical evidence, nor any presumption from economic theory, that lowering inflation will of itself promote growth.

32. This conclusion does not, however, necessarily dispose of Outlook's policy prescription of sticking to the "broad thrust" of present policy strategies for it might still be argued that, although this will not restore growth and still less eliminate unemployment, nevertheless the outcome would be less bad than could be attained by any other route.

33. We must still, therefore, look both to the causes of present inflation, to the question whether monetary restraint is the only means to reduce it, and whether there are feasible alternatives to present policies.

#### The causes of inflation and possible remedies

34. Inflation, by which we mean a continuing rise in the level of prices, is a condition which has been endemic in all industrial countries throughout the past forty years. It is difficult to find any country where, for as long as a single year, the general price level has remained lower than in the previous year. Many people nowadays speak of the 1950s and 1960s as though they were a period of price stability. The fact is that in most industrial countries prices were rising on average around 3 per cent a year - some slower, some faster, and that in many countries rates of 4 or 5 per cent a year would have been judged to have been unacceptably high. What has happened is that today rates above 10 per cent per annum have come to be regarded as too high (we are now speaking of industrial countries) but the rates of 4 or 5 per cent are considered desirable targets. The fact that inflation has become endemic suggests that it may be more productive to ask the question what keeps it going and what factors may speed it up or slow it down than to ask what set it going in the first place. There was a time when the standard objection to inflation was its alleged unfavourable effects on the distribution of income, favouring profits and the wages of well-organized labour to the detriment of rentiers, salaried persons whose nominal incomes were adjusted at only very infrequent intervals, pensioners, and so on. As inflation has persisted, so gradually the disadvantaged social groups have endeavoured to remedy the situation by collective action or legislation so as to achieve de facto or de jure indexation. The extreme instance of this is perhaps Israel where so many contracts have now become indexed that for practical purposes the particular rate of inflation of the shekel appears to be a matter of indifference. It is arguable that once everything becomes indexed there is no point in inflation: nevertheless indexation is the route which individual groups strive for in their efforts to defend their own position. In a closed economy with complete indexation at discrete intervals there would presumably be a steady rate of inflation.



35. Two factors might be expected to slow down such a steady rate, a persistent favourable movement of the terms of trade or a tendency for productivity to increase unusually fast. In either case maintaining one's position as regards real income would be consistent with prices rising ever more slowly, or even falling. Both these factors were favourable to low inflation in the 1950s and 1960s. It seems possible that the dampening effect of high productivity increases was diminishing as wage-earners became accustomed to regular increases in real wages which they endeavoured to consolidate in wage contracts. In such circumstances, if there is a slowdown in productivity growth, such as occurred in the 1970s, such real wage aspirations become a factor making for faster inflation. In the same way the reversal of the terms-of-trade movement intensified inflation in the industrial countries and, in particular, the two great jumps in oil prices gave a sharp twist to the cost-price spiral. The momentum of any inflationary spiral will become greater if expectations of further price rises become firmer and firmer in the light of past experience.

36. While Outlook would probably not question the influence of the above factors it appears it has put much greater store on the growth of public expenditure, and especially of budget deficits in generating inflation. While it is not difficult to point to individual cases in the past ten years where increases in public expenditure have been excessive, it is not easy to see why, in general, the rise in public expenditure could have been so decisive. It has not been to any great extent an increase in claims on goods and services but, as Outlook 1982 points out in an Appendix, an increase in transfers. There is no reason for transfers, which are financed by social security contributions or taxation, to cause inflation. Obviously higher expenditure of any kind may make deficits more likely because of the reluctance of governments to raise taxes, but not all deficits can sensibly be said to be inflationary either. There were two reasons why higher deficits in the last ten years were to be expected: increases in oil prices generated huge balance-of-payments surpluses for oil producers, which were bound to persist because of limits to their immediate capacity to import. Consequently, oil consumers were bound to encounter corresponding balance-of-payments deficits. If they decided not to attempt to close the gap at once, but only slowly, then the shift in their current-account targets would require a matching shift in one or more of the financial balances of the personal, corporate or public sectors. Some contribution from the first two might be allowed for, but if a sharp deflation were to be avoided the obvious move was to allow a compensating change in the target for the budget balance. This might well require a corresponding adjustment of monetary policy if contractionary pressure were to be avoided. Of course, such adjustments entailed the passing through of the oil price rise into the general level of prices. The alternative would have been to attempt to ensure that any rise in oil prices was fully compensated by falls in non-oil prices, a point which will be discussed below.

37. The second reason for expecting larger deficits has been the recession, to the extent that it originated in the private sector. Such a decline in activity causes a loss of revenue and triggers off automatic increases in unemployment compensation and the like. The need

to allow, in interpreting the significance of deficits, for some kind of "cyclical" adjustment is fully recognized by Outlook 1982 in a technical appendix, although there is no reference to this aspect of fiscal policy in the discussion in the main text. Outlook appears to take the view that a deficit would not be inflationary if covered by long-term loans, but would be if monetised. More than that, if market participants come to believe that, though currently loan-financed, a deficit would be monetised at some future date, that too would be inflationary. In all this Outlook exaggerates, I believe, the importance of the particular method of financing to the likely inflationary consequence of any given deficit and pays insufficient attention to the condition of the economy at large in determining whether or not a particular deficit is likely to intensify inflation. In deep recessions, for instance, it is likely that changes in public expenditure, given tax rates, or changes in tax rates, given expenditure, will have a greater effect upon real demand and output, either at home or abroad depending on the marginal propensity to import, than upon prices.

### The present recession

38. When it is asked why this or that particular economy is in recession the answer is commonly given that this is because there is a world recession, but this is a very incomplete answer since the "world" is made up of the sum of this and that particular country. It is easy to see that from the point of view of a single country A, if all the others go into recession, the demand for A's exports will fall off, leading A into recession as well, especially if A's authorities take restrictive action to avert a current-account deficit; this still leaves unanswered the question why all the other countries went into recession in the first place. The answer can only be found in one of two directions. Either it is the case that market economies, left to themselves, are subject to periodic booms and slumps or we must believe that recession is the consequence of deliberate action of governments.

39. The most obvious explanation of the current recession is that inflation had been rising for the reasons already given, with additional impetus generated by oil price increases. Governments became increasingly worried by inflation, and adopted restrictive monetary and fiscal policies with a view to bringing it down. These policies have had some success in decelerating inflation but they have also brought about a rise in unemployment. In addition, the rate of investment has fallen away, and for this and other reasons, the rates of growth of productivity have slowed down. The question now is whether, as Outlook suggests, present policy strategy should be persisted in or whether it is possible to relax sufficiently to reverse the trend of unemployment without causing inflation to accelerate once more. The further question is whether there are alternative means to curb inflation without such high losses of output and employment. Before answering these questions it would be convenient to insert a brief digression on "monetarism".

The monetarist view

40. Any general discussion of the various brands of "monetarism" would carry us too far afield, but it so happens that the British Government, which came into office in May 1979, chose to formulate its medium-term financial strategy in unusually explicit terms in the Financial Statement and Budget Report which accompanied the Budget in 1980. That statement justifies the characterization of British policy as "an experiment in monetarism".<sup>3/</sup>

41. Though there have been adjustments to the original strategy, the central ideas have not changed. In the first place the Government saw its task as getting "monetary conditions" right: it did not intend to set specific objectives for the growth of real demand or activity, or even for the rate of inflation itself, since it could not control them. It could, however, take steps to improve the "supply performance of the economy", and there was an expectation that bringing down inflation would itself promote a "sustainable growth of output and employment". In the event the attempt to use monetary aggregates as the centrepiece of strategy was not a success. In six out of eight target periods since monetary targets were first introduced in Britain in 1976 (i.e., before the Medium-Term Financial Strategy itself was adopted), the actual rate of growth of  $\text{£M}_3$ , the chosen aggregate, was outside the target range, too high five times and too low once. This might have reflected a lack of total commitment to the policy; it also reflected practical problems. The instruments under the control of the authorities are short-term interest rates (within certain limits) and fiscal policy, but the relationships between these and the monetary aggregates are obscure, slow-acting and imprecise.

42. Different monetary aggregates, notably  $M_1$  and  $\text{£M}_3$  are not clearly correlated, and often generate contrary signals. Yet the nature of monetarism requires the singling out of one aggregate, to which the markets should pay attention, to the exclusion of all substitutes. This is especially required in the more modern version of "monetarism" which invokes the idea of "rational expectations", whereby market participants are presumed to understand fully the impact of monetary policy changes upon the economy. After the event, it is always possible to pick out one aggregate, or to construct some weighted average of several, which would have been the best guide to monetary conditions in some past period. This, of course, presupposes that the course of events would have been the same, even though the monetary targets had been different, and this is questionable. In any case the object is not to be wise after the event, but to choose the right aggregate before the event.

43. To sum up, the British authorities found that they did not know what actions they should take using the instruments under their control to hit the monetary targets they had set themselves. Even if they had hit the targets they would not have known with any confidence the implications for output and inflation. Old-fashioned monetarists acknowledged that setting low targets for the money supply would entail some "transitional unemployment" while inflation was being gradually



brought down: in the more modern "rational expectations" version everything was expected to happen very much more quickly since, once market participants had taken on board that the monetary authorities meant business, inflationary expectations, and hence inflation, would respond very quickly.

44. In the British experiment the transitional unemployment has proved to be much larger and much longer lasting than was contemplated by those advocates of the policy who have brought themselves to comment on this point. Between 1979 and 1981 GDP fell by 5 per cent and manufacturing output by 15 per cent; unemployment rose from 5.4 to 10.6 per cent, and is now over 12 per cent. Official Government spokesmen have been saying that the recovery was about to begin for well over 18 months, but to date there is no sign of it. There has been success in reducing inflation, but as the months pass and there is still no sign of recovery, the band of those who believe that stopping inflation is itself sufficient to put the economy on a path of sustained growth, is steadily diminishing.

45. The British experience is, of course, for one country only. To generalize from it might not be justified, but to ignore it would be even less so. The author's contention is that continuance with the "broad thrust of present policy strategies" would not lead to spontaneous recovery. The British evidence to date supports that view. Those who take a contrary view need to explain why the British experiment has failed to work so far.

#### Reflation and Expectations

46. In the author's opinion Outlook places too much weight on the supply side factors in explaining the rise in unemployment and too little on the demand deficiency which has been brought about by the "broad thrust of present policy strategies". In many instances the strategies have intensified unemployment and in the longer run they may have contributed something to the slowing down of productivity growth. This last point is of some importance. Outlook's prescription is to keep the "pressure of demand" low in order to tame inflation but at the same time it urges the loosening of various "rigidities" in the labour and goods markets. Its central scenario A is dependent on some success in this direction but the fact is that low pressure of demand is more likely to intensify rigidities than to loosen them.<sup>4/</sup> There is now a considerable "demand deficiency" unemployment in most industrial countries - more in some than in others - so that it would be sensible to reverse the thrust of monetary and fiscal policies, but how far can one go? And what about the danger of reviving inflationary expectations, and hence inflation?

47. The role of expectations in economic decision-taking has been very much stressed in recent years. Some exponents of the "rational expectations" school have come forward with strong propositions concerning the impotence of "demand management" because market



participants are not fooled by governments and whenever the latter make a move, such as increased deficit spending, market participants promptly adjust their behaviour, e.g. by saving more, in such a way as to offset the impact of the government's action. The models which are used, however, are usually far too simple to justify drawing firm conclusions for the real world. Nevertheless, one cannot shrug off the problem of expectations.

48. Expectations can, of course, be disappointed, but if market participants think there is going to be inflation they may well take action which will help to bring it about. For instance, if inflationary expectations rise in country A, investors may transfer funds from A to countries B or C, whose currencies are thought to be more stable. A's exchange rate will fall, putting up the domestic price of imports and eventually pushing up the general price level.

49. There seems to be little doubt that financial markets have become more sensitive to such considerations than previously. Moreover, there has been an intensive campaign to decry any past success of "demand management" and suggest that any return to demand management today would only generate inflation. *Outlook's* own observation is: "Experience of the past decade provides strong evidence that the probable outcome of a shift to more stimulative monetary policies at this time would be higher growth in the short-term followed by an acceleration of inflation necessitating an eventual return to severely restrictive policies". This is a comparatively cool statement and is confined to the 1970s. Politicians are less careful, and more than one national leader, whose government is now pursuing a restrictive policy, has argued that all previous administrations pursued wrong-headed expansionist policies. It is not just five or ten years of mistakes, but twenty or thirty years or more of error which have to be corrected. It would be idle to pretend that this barrage of propaganda, put out by some economists, but above all by some newspapers and politicians, has not had an effect. In consequence the politicians have painted themselves into a corner by decrying so vigorously all previous administrations for "giving way", "doing U-turns", and the like. They have put their own creditability on the line, for even if they were to become convinced that deflation has been carried too far, some of them would find it difficult to announce a change of direction. This does not mean that reversal is impossible; that would be to say that no human error can ever be corrected. But it will be difficult and call for much explanation to the public why new circumstances call for new measures, and so on. A gradual change may have more chance of success than a violent shift into reverse.

50. The chances of success would be much increased if all major countries reflationed simultaneously or, at the very least, endorsed the propriety of reflation of those considered to be most favourably placed. One immediate obstacle to a reflationary U-turn in any one country is the fear of a run on its currency. If market participants, rightly or wrongly, believe the move to be unsound they will transfer funds elsewhere. But if all countries reflate together, or endorse the reflation, this source of disruption is much less significant.

51. When output rises, whether because of a spontaneous recovery in private consumption or investment, or as a consequence of a monetary or fiscal stimulus, the demand for inputs into industry will also increase. For some intermediate products, like steel, it is unlikely that any increase in demand will affect prices; there will simply be an increase in output. In other cases, such as minerals and agricultural products, where stocks are low and supply inelastic in the short run, there will be rises in prices which will in due course bring forward additional supply. These price increases will, of course, mean higher costs in industrial countries. But to object to them as reviving inflation would be the height of absurdity. It is precisely a fall in commodity prices as a result of recession which has contributed considerably to the reduction of inflation in industrial countries and which, as we argue in the next section, has gone too far. A recovery of primary product prices is not objectionable, but positively desirable. Clearly, if basic conditions in industrial countries similar to 1972-1973 were to recur, the rise in primary product prices might be reinforced by speculation and go "too far". But that is not a realistic contingency in the foreseeable future. In Outlook's optimistic scenario C the terms of trade of non-oil developing countries improve by only 1 per cent a year, compared with a worsening of 6 per cent forecast for the single year of 1982.

52. With labour inputs the evolution is likely to be different. There may be exceptions in industries of new technology, but in most industries in the majority of countries there is considerable under-utilized capacity. Rising demand and output will lead first to an increase in productivity and then an increase in employment. In neither case is a rise in nominal unit labour cost to be expected, over and above which would otherwise have occurred, bearing in mind that there is already a cost-price inflation in being. In some cases unit labour costs might fall (relatively) and profit margins rise. However, as unemployment begins to fall significantly, the danger of renewed wage inflation returns. Some countries have always operated some kind of "concertation" or incomes policy, so that the risk of inflationary explosions is obviated, but for others the co-existence of full employment and price stability, without any reform of the system of pay and price determination, is a myth. How far reflation can safely go depends on the particular circumstances in different countries.

53. Whether it will be possible to reduce unemployment to the low levels which prevailed in the sixties can only be found by experience. It is plain that besides demand deficiency, there is a number of longer-run supply factors which contribute to raising the "natural rate" or "full employment rate" of unemployment. Various "long-run" measures, such as industrial training and re-training, can be taken to improve the labour market and reduce these critical rates of unemployment. But whatever is done in this respect success will very much depend on the degree of "concertation" achieved between the social partners. Outlook acknowledges the potential importance of "concertation" between the social partners, but argues that more formal types of incomes policy have rarely been successful. The trouble has been that too often such policies were introduced hurriedly in an emergency and hence were too rigid from the start; the longer they were in place the greater the

strains imposed upon them until they crumbled. It is important for governments, business and trade union leaders to grasp that a return to full employment in the modern world is only possible if new and permanent arrangements are made to tame inflation.

54. Is there then any alternative to the "broad thrust of present policy strategies" advocated by Outlook? Outlook offers scenario A as its "central projection" but this scenario is too optimistic. In the first place it assumes significant loosening of various rigidities, whereas the evidence suggests that keeping the pressure of demand low is more likely to intensify them. Outlook also rightly warns against protectionism. But it is not possible to maintain high unemployment and to keep protectionism at bay. Of course unemployment is not the only factor making for protection; after all, the European Common Agricultural Policy, a thoroughly protectionist device, if ever there was one, was put in place when European countries were growing fast and had low unemployment. But there is everywhere evidence of increased pressure for protectionism and the recent meeting of ministers in GATT did little to stem the tide. The influence of unemployment, or its threat, is too obvious to be ignored. Reversing the engines, and embarking on a gradual reflation of industrial countries designed to stop the rise and start the fall of unemployment will not stop the protectionist movement in its tracks but the strength of the movement may cease to grow once it is perceived that the creation of new jobs is beginning to overtake the destruction of old ones. The chances of any one country, except possibly the very largest, getting far with reflation on its own, are slim. Expectations are important, and investors have been taught to distrust reflation. Governments going it alone for expansion are very likely to find themselves also going hard for protection.

55. To continue with present policies may well bring inflation down faster than otherwise in the short-run, but it is to go along a road which will, in all other respects, get stonier and stonier. Rigidities will not be loosened but intensified; protectionism will get stronger, leading toward the eventual break-up of the present world system. The likelihood of "spontaneous recovery" simply as a consequence of reducing inflation itself is small.

56. What is now needed is a programme of reflation to start recovery on its way. The particular mix of monetary and fiscal policy will depend on the circumstances of particular countries. Reflation means starting on a new road, but in that road, too, there are obstacles. Financial markets are sensitive, and too much has been said in recent years about the alleged therapeutic value of monetary contraction. Governments and central banks will need to explain what new measures are needed. Expansion will help in loosening rigidities and resisting protectionism, but it is no panacea. There are longer-run supply problems which need to be tackled in their own right. In the nature of things improvements from such sources are likely to come very slowly, and it would be perverse to insist on waiting for the success of long-run measures before taking whatever gains are immediately available from reflation. How big such gains are varies from country to country.



57. Just as contraction in one country reinforces contraction in others, so that all are brought into recession together, so is it impossible for any one country to break out on its own. If the industrial countries are to recover they must act together to buttress one another's expansion.

#### The problems of developing countries

58. Following the first major increases in oil prices most of the oil-exporting countries developed large surpluses in their balance-of-payments current accounts which were only gradually run down as the development programmes of the oil exporters required them to absorb increasing quantities of imports. Meanwhile the surplus funds were lodged inter alia with the Western banking system which lends substantial amounts to non-oil developing countries. In the middle of the 1970s many developing countries enjoyed high and still rising export prices and were able to borrow funds at rates of interest no greater, and even smaller than, the rate of inflation. A similar expansion of lending followed the second round of increases in oil prices. The consequence is that non-oil developing countries have accumulated very large external debts owing in the main to private banks. The servicing of interest and any amortization of these debts must, of course, come out of earnings from current exports. Already the indebtedness of developing countries has reached crisis proportions in a number of instances. Private banks, central banks and the IMF have been involved in a number of emergency exercises to prevent the indebtedness of particular countries breaking out into a financial collapse which would have world repercussions. With this "fire-fighting" activity I shall not be concerned. What is of concern here is the impact of alternative scenarios for the industrial countries upon the prospects of the developing countries.

59. Outlook provides estimates of the current balance and the debt burden of different groups of developing countries corresponding to the three scenarios A, B, and C, in the industrial countries with certain additional assumptions added. They are: (i) real interest rates in international markets are gradually reduced, reaching 2 per cent by 1986; (ii) oil prices stay constant in real terms at the projected 1983 levels; (iii) the trade restrictiveness of the industrial countries towards the developing countries stays where it is, and (iv) official development assistance is maintained in real terms from 1981 to 1986.

60. Outlook takes the view that scenario A would provide a modestly satisfactory outcome for the non-oil developing countries. Under it, adjustment programmes will be accompanied by the lower rates of growth which have prevailed since the mid-1970s. Among them the major exporters of manufactures will depend on there being no growth of protectionism in the industrial countries. Others, notably those depending on the export of primary products, would face severe financing problems. They will normally need "more time and investment".



61. These Outlook judgments are clearly based on an enormous volume of detailed experience of individual countries but, as in the case of the industrial countries themselves, one may hazard a guess that scenario A errs on the side of optimism. In particular the likelihood is that the protectionism of industrial countries will increase and, on average, hit hardest developing countries which export manufactures. More important perhaps is the fact that the comparatively sluggish growth of industrial countries in scenario A may mean little improvement in primary product prices which have fallen to exceptionally low levels as a result of the recession. Scenario A still requires monetary restraint, suggesting that real interest rates may not come down all that much. Developing countries as a group now carry very large debts and high interest rates mean the pre-empting of a considerable part of their export earnings to service debt. If they have to adjust their balances, and there is no growth of markets in the industrial world, they will be obliged to contract so as to reduce imports. But this road leads only downhill. Reduced imports of developing countries mean reduced exports of industrial countries, a further contribution to recession. Any programme of world economic recovery must contain within it the growth, not the decline, of world trade.

62. The most immediate problem for several developing countries is undoubtedly the avoidance of default. But though essential, the staving off of financial crises is only the first step. If developing countries are to remain economically viable they must be able to service their debts, but to make this possible they must be enabled to earn increasing amounts from their exports. There is no prospect of this unless the industrial world is expanding.

### Conclusion

63. The industrial countries may be able to put up with prolonged stagflation. By historical standards they are wealthy, and in many countries social security arrangements may take the worst edge off poverty. Even so, prolonged stagflation does nothing to strengthen the foundations of industrial countries. Moreover the denial of the opportunity to work for so many people for so long is bad in itself, and potentially politically destabilizing. But the impact of prolonged stagflation of the industrial world in many developing countries is far more serious. Whichever way they turn, they will be denied the possibility of achieving reasonable economic development by their own efforts. What they need most of all is lower interest rates and an opportunity to market their products at prices which will enable them to grow as independent economic entities. But this will not happen so long as industrial countries adhere to present policies.

64. The first step is to set the industrial countries once more on the road to expansion. Acting alone few countries could go far along this road without running into trouble, but acting together they can give mutual support to one another. There is little immediate danger of a new explosion of inflation, but the fear of revival of inflation once output and employment rise strongly is one which cannot be ignored.

Governments can give a lead by explaining the need for new measures, but a lasting programme of recovery calls for co-operation between the social partners and governments just as much as there is need for co-operation between nations.

#### FOOTNOTES

1. The growth and inflation rates in the three scenarios can be combined to show the implied increases in nominal GNP. This is done in the table, to the nearest decimal place. Where an inflation rate was given as 4 - 4.5 we have used 4.25.

#### Implied changes in nominal GNP (per cent)

	<u>1984</u>	<u>1985</u>	<u>1986</u>
Scenario A	9.4	8.0	8.6
Scenario B	9.4	10.9	10.9
Scenario C	9.5	9.0	8.7

What is striking about these figures is that virtually identical profiles of nominal GNP accomodate the optimistic and central scenarios but not, apparently, the pessimistic one. There could be a logic behind these numbers, but it is not self-evident.

2. National Institute Economic Review, November 1982, p. 48.
3. The comments which follow draw heavily on a more extended analysis in the National Institute Economic Review, November 1982.
4. See, for instance, G.D.N. Worswick, "The Relationship between Pressure of Demand and Productivity", in Slower Growth in the Western World, edited by R.C.O. Matthews, Heinemann, London, 1982.



LOW INCOME COUNTRIES AND THE INTERNATIONAL  
MONETARY SYSTEM

Group of Experts



Letter of Transmittal

12 January 1983

Dear Mr. Secretary-General,

I have the honour to submit herewith a report entitled "Low-Income Countries and the International Monetary System". The report was prepared by an expert group under the auspices of the UNDP/UNCTAD Project INT/81/046. The members of the Group, who acted in their personal capacities, were the following:

Professor Compton Bourne  
Dr. Mario Gomez  
Professor Reginald Herbold Green  
Dr. Alassane Ouattara  
Professor G.O. Nwankwo  
Professor Rehman Sobhan

The Group held its first session from 8 to 10 February 1982, and a second session from 10 to 12 January 1983. Dr. Alassane Ouattara was unable to participate at the second session.

I believe that the report, which was adopted unanimously by those present at its final meeting, is a timely contribution to the consideration by the international community of a problem of great urgency, namely, the devastating effect upon low-income countries of the current world recession, and the inadequate provision for these countries in the international monetary system.

Accept, Sir, the assurances of my highest consideration.

(signed) G.O. Nwankwo

G.O. Nwankwo  
Chairman of the Expert Group

Mr. Gamani Corea  
Secretary-General of UNCTAD  
Palais des Nations  
1211 Geneva 10, Switzerland

PREFACE

The following report is addressed to the special problems faced by low-income countries in accommodating their economies to the vagaries of an increasingly unstable international monetary system. The low-income countries share with other developing countries all the well-known weaknesses characteristic of developing countries as a whole, such as vulnerability to business fluctuations emanating from abroad as well as to protectionist restrictions imposed by other countries on their export trade, the limited diversification of their exports, the difficulties associated with their position as price takers, for the most part, rather than price makers in world trade, the limited margin for manoeuvre afforded by inadequate reserves both of essential goods and of foreign currencies, and the immense problems of adjustment that result from the rigidities of their economies and the immobility of their resources. It is therefore natural that the low-income countries resolutely support the Blue Book on International Monetary Reform adopted by the Ministers of Finance of the Group of Seventy-Seven at their meeting in Belgrade in September 1979.

The fact that low-income countries are in most respects quite similar to other developing countries in their political, social and economic make-up does not mean that their problems and options are identical with those of their more advanced developing country neighbours. It has long been apparent that there are differences between low-income countries and other developing countries that are of considerable importance - differences that will be described in some detail in the main body of this report. The significance of these differences was clearly recognized by the IMF when it established a Trust Fund and a subsidy account to assist a limited group of member countries - despite the Fund's well-known objections to discrimination in favour of particular countries within the international monetary system.

Since the early 1970s the relative position of the low-income countries has been sharply eroded. The relative displacement of IMF balance of payments support by commercial bank lending has meant a corresponding deterioration in the ability of low-income countries to achieve a satisfactory combination of adjustment and financing. Since most of these countries are not deemed creditworthy by the private banks, the IMF is for them the only possible source of balance of payments financing and not merely the lender of last resort. Since IMF financing has been inadequate as regards both volume and terms, the low-income countries have been forced, under conditions of persistent world recession, to retrench much more drastically than other groups of countries, despite the fact that their low income levels leave them with much less margin for such retrenchment than other countries have.

Under current conditions, moreover, the international community is understandably preoccupied with the problems of large debtors that impinge on the financial stability of the major industrial countries and hence of the world as a whole. The rescue operations that have been

mounted in support of these countries have been impressive in their promptness and scope. In this process, however, the fact that low-income countries are in an equally if not more difficult position has been virtually overlooked, and for them no relief is in sight.

In the view of the Expert Group, it is particularly critical at the present time that priority attention be given to this problem which the international community cannot afford to neglect without running the danger of massive political and social upheaval in the countries concerned.

(signed) COMPTON BOURNE

(signed) G.O. NWANKWO

(signed) MARIO GOMEZ

(signed) REHMAN SOBHAN

(signed) REGINALD HERBOLD GREEN

## Introduction

1. The stake of the developing countries in the international monetary system (IMS) - by which we mean primarily the rules, institutions, policies and practices regarding the adjustment and/or financing of external imbalances, the creation and distribution of international liquidity, and the determination of exchange rates - stems very largely from the vulnerability of developing economies to exogenous shocks and the difficulties these shocks pose for economic management generally, and the management of the payments position in particular. Within the broad group of developing countries there are sub-groups of low income and structurally disadvantaged countries for whom vulnerability is even greater and existing lines of recourse to the international monetary system for support even less adequate. This report relates primarily to the present position and immediate requirements of these economies, but does so within the context of global developing country/international monetary system interaction.

2. It is well to remember, in this context, that the international adjustment process is asymmetrical. For one thing, countries in surplus are under far less pressure to correct the imbalance in their payments than are deficit countries; the former generally enjoy ample room for accumulating reserves, whereas the latter face rather tight limits on how far they can draw on their accumulated stock of reserve assets or borrow. This asymmetry hurts all deficit countries, but most especially low-income countries. It is these countries, therefore, which bear the brunt of the failure of the international monetary system to provide for effective means to adjust surpluses or finance the corresponding deficits on a long-term basis.

## Size and source of the payments deficit of developing countries

3. Over the last few years, developing countries have faced intense and growing pressure on the balance of payments. The energy-importing developing countries suffered a deterioration in their terms of trade of nearly 6 per cent per annum from 1978-1981, due to a weakening of commodity prices resulting from recession in developed countries and a rise in import prices.

4. The purchasing power of exports (calculated on 1978 export volume and 1978 prices) fell by 20 per cent from 1978-1981, which represents a cumulative loss of over \$ 40 billion over the period (in 1978 prices) - a figure corresponding to the entire capital inflow and to two-thirds of the foreign exchange holdings in 1978. There can thus be little doubt that exogenous factors have been adversely affecting the payments position of most developing countries with great force, and account for the big deterioration in their external accounts.

5. Since external financing has not sufficed to offset the pressure, import growth in energy-importing developing countries has dropped to



very low levels - 1.3 per cent in 1980 and 2.0 per cent in 1981: for many countries there has been a cut in the absolute level of imports. Rates of growth of gross domestic product have also taken a sharp cut, from 4.1 per cent in 1980 to 1.4 per cent in 1981 and an estimated 0.5 per cent in 1982, and in many countries there has been a contraction of production per capita. Because these rates are in constant prices, they overstate growth of national purchasing power (including command over imports) during periods of worsening terms of trade. Given the terms of trade decline, the 1981 growth of real purchasing power of these economies was approximately 0. In other words, not only has there been a loss of real income due to external factors, but a major erosion in the capacity of many countries to increase output pay to offset the loss.

#### Low income and structurally disadvantaged countries

6. Developing countries diverge substantially in respect to their vulnerability to external shocks, their capacity for domestic management of exogenously generated instability and their effective access to the international monetary system for interim and long-term resources to meet crisis needs, including structural adjustment and enhancement of production to regain balance. Those countries with particularly low incomes - per capita and absolute - suffer from a series of interlocking structural handicaps to a greater degree than other developing countries. In times of extreme global monetary and financial stringency and uncertainty combined with sustained recession in the industrial countries, the number of developing countries suffering from extreme structural handicaps broadens. Characteristics leading to high levels of vulnerability, limited capacity for domestic response and inadequate access to international resource flows include:

(a) Low per capita income. The poorer the country the less the margin for cuts without massive damage to essential consumption, basic services, new investment to restore balance, and replacement investment to maintain existing capital stock and productive capacity. Cuts in the income of the absolutely poor threaten nutrition, health, shelter, clothing and life expectancy directly. Reduction in public services falls heavily on primary and adult education, pure water supply, agricultural extension, and preventive and basic curative medicine. Falls in public revenue and in surpluses of production enterprises prevent adequate maintenance of existing assets let alone new investment to alter production patterns in accordance with higher export generation and import saving requirements.

(b) Low national income. Low overall national income is usually associated with a larger share of imports and exports in monetised GNP. It is also associated with a limited range of exports and limited ability to alter the composition of exports in response to international price fluctuations paralleled by heavy import dependence for essential products often including fuel, food and capital goods. Therefore, low national income countries are more susceptible to international demand fluctuations and less able to respond by altering export and overall production patterns than are larger economies.

(c) The elasticity of imports and exports. Inasmuch as the pattern of home demand in low-income countries differs from that for internationally traded goods, lowering the domestic absorption of goods and services will not serve to expand the volume of exports to an equal degree; inflexible marketing and distribution arrangements, and other such factors (including transport costs) impeding access to foreign markets will also limit the elasticity of demand and supply of exports. Similarly, where the import bill is largely made up of essential items (such as, for example, basic foods, fuel, raw materials and machinery) and where capacities used in the production of non-essentials for the home market cannot be redeployed to substitute for imports, a compression of import levels, before new investment has taken place and yielded its results, will require a reduction in the level of output itself instead of merely lowering the import content of the output. The lower the elasticities of substitution in consumption and production, the costlier it is to correct a payments deficit in the short term (that is to say, without a prior increase in productive capacity). While low elasticities of substitution are by no means unique to low income countries, their impact is usually more severe for such economies because of the greater divergence between export and home demand patterns in these countries and the lower share of the more flexible manufacturing sector in production and in exports.

(d) Limited access to international capital markets. Countries with low per capita and low total GNP tend to have limited access to international commercial bank credit especially under those conditions of external imbalance crises and global uncertainty when they most urgently need such resources. In practice the access of the least developed countries to such credit has usually been negligible and at present a far broader range of low and middle income developing countries have no substantial access to commercial bank credits.

(e) Relative systemic unimportance. Where a major developing country faces serious external difficulties, such as a debt crisis, the international community attaches high priority to devising a solution and accepts a not insignificant degree of bargaining leverage from the borrower because of the mutuality of the interests involved. In the case of low income and structurally disadvantaged countries, perception of mutuality of concern in survival is much weaker, and there is much less interest in locating financial resources, or in negotiating (in contrast to imposing) a package of external and domestic adjustment measures.

7. There are a number of other points to be made in connection with the above characteristics.

(a) A country's ability to cope with deteriorations in its current account balance is also related to its position on long-term capital account. In addition, the larger is the flow of aid relative to the exports of a country, the smaller will be the proportion by which its imports would need to be cut in order to compensate for a reduction in export receipts by any given amount. Moreover, the more a country's savings are supplemented by ODA, the higher will be the level of investment and hence the scope for adjusting the pattern of production.

(b) Also of importance, from the standpoint of payments adjustments, is the degree to which external assistance is fungible. To the extent that the aid flow is tied to specific projects, it cannot be used to pay for imports of essential production inputs such as fuel and raw materials; nor can it be redeployed to accord with a new set of priorities to which a more constrictive payments situation may have given rise. Rigidity in the use of aid compounds other structural rigidities and reduces the ability to alter overall external resource use patterns promptly in response to exogenous changes.

(c) It has already been pointed out that countries most prone to incur deficits as a result of exogenous events are the main victims of the asymmetry in the positions of deficit and surplus countries. By the same token, it is those deficit-prone countries that are least able to cover their deficits with reserves and borrowing on whom the asymmetry bears down most heavily. The least developed countries clearly fall within this group as do all characterized by low per capita and national incomes. During periods of global economic recession and monetary stringency, the number of countries seriously affected broadens.

8. Developing economies as a whole are particularly vulnerable to changes in the international economic environment and particularly limited in their access to the international monetary system when the comparison is with high income industrial economies. However, the degree of vulnerability and of access (or lack thereof) is not uniform within the developing country group. Low income countries - both in per capita and overall GNP terms - tend to be more severely affected on both counts especially during crisis periods like that beginning in 1979. Therefore, within the overall developing country objective of international monetary system reform, special attention should be given to those measures which are particularly important to ensuring survival of low income economy production and consumption capacity as well as ability to achieve structural change during the present crisis.

9. In large part, low-income countries can and do protect themselves from payments deficits by accumulating foreign exchange reserves when the payments situation is relatively favourable, and drawing upon them to finance deficits in bad years. However, this does not remove the burden arising from their handicaps, since reserve accumulation has an opportunity cost - a high one for countries whose growth is, at the best of times, constricted by import capacity. Nor is it always feasible: exposed and vulnerable countries are not in a position to predict with accuracy either the trend or the fluctuations in export earnings and import prices. In any case the volume of reserve levels needed to offset 50 per cent falls in the terms of trade and in earned import capacity (amounting to 10 to 15 per cent of pre-crisis national purchasing power) over 1978-81 is one implausible for any country to achieve, let alone a poor one. Yet those are the types of decline in import capacity which have confronted many low income economies. It is to be expected, therefore, that reserves will prove inadequate from time to time. It would, for example, be difficult to fault a country for not anticipating strong pressure on the external balance if that were the consequence of an exceptionally long and severe recession elsewhere, or



the result of prices of essential imports moving upwards and staying up (or moving up further) owing to unpredictable events (such as war or revolution). Indeed if such developments occurred simultaneously, reserve depletion might be unavoidable; nor would it be surprising to find many countries which would, in normal conditions, be able to tide themselves over with commercial borrowing, now unable to attract bank credits. In other words, low-income developing countries have, because of the impact of external economic forces and the uncertainties surrounding them, a relatively high need for reserves and, because of their development needs, a relatively low capacity to accumulate them in sufficient quantities.

10. Low-income countries lacking the commercial borrowing option are thus especially dependent on official payments support. The volume, terms and duration of access to IMF resources are issues of key importance to them. The policies and practices of the IMF are no less significant. For that reason, it is to be expected that if IMF conditionality is stringent, the impact will not be equal even if the conditions are equally stringent for all countries drawing upon the IMF. It is the countries most dependent upon it that will in consequence be most constricted.

11. Any improvement in the current account through adjustment of the volume of exports and imports involves a sacrifice (unless underutilized resources can be mobilized for that purpose). Adjustment of the current account can, however, entail additional costs if compressed into an unduly short period of time. These can take the form of lowered levels of capacity utilization, or of disruption to development programmes.

12. The extent of the transitional costs incurred will depend critically on two factors: first, the size of the turnaround sought in the current account over any given period of time, and second, the degree to which patterns of consumption and production are flexible. Where internal resource mobility is low, swift adjustment in the external sector will result in an internal imbalance, with possibly severe consequences for the long term development of the economy.

13. Where the external imbalance is the result of a recent over-expansion of spending, it is to be expected that the current account will respond much more swiftly to disinflationary measures, and that the reduction of effective demand will have a smaller and more transitory effect on capacity utilization than where changes in the structure of production are called for. Similarly, where the external imbalance results from falls from previously achieved export volume levels (especially of manufactured goods) related to recent over-valuation of exchange rate, a currency devaluation can be expected to bring a speedier correction in the current account than where import replacement or export expansion requires the establishment of new lines of production.

14. Where the external imbalance is the result of a deterioration in



the terms of trade (or decline in capital inflows), the perceived excess of aggregate demand over aggregate supply corresponding to the external deficit is best viewed as being the consequence of a shift in the supply curve rather than of the demand curve. For example, in a number of Sub-Saharan African economies and other low-income countries real import volume, real produce prices, real wages and salaries and real government expenditure have all fallen in recent years in large part because of terms of trade deterioration of up to 50 per cent. This pattern - even if accompanied by inflation - can hardly be interpreted as external imbalance caused by runaway domestic demand. This distinction is useful not only as a diagnostic device but also for the prescription of policies, since it points to the need to increase the capital stock and to change its composition. Adjustment in the foreign balance is more difficult and complicated when the imbalance is in the pattern of supply, in particular between the foreign trade sector and the non-tradeables sectors, and within the foreign trade sector, rather than in the overall relation of expenditure to output.

15. To the extent that capacities are not readily switchable from production for the home market, correcting a foreign deficit requires changes in the patterns of production involving expansion of capacities, i.e., new investment, in export and import-substituting goods. A compression of demand for non-tradeables is likely to increase the supply of tradeable commodities only to a moderate degree, depending on the pattern of consumption and the extent to which the two sectors compete for production inputs such as building materials and skilled labour. Forcing the pace of adjustment between the two sectors is likely to result in substantial costs being incurred: it will render idle those resources employed in the non-tradeables sector for which the tradeables sector has and will have no productive use, as well as those which the tradeables sector will not be able to absorb usefully until additional capital stock has been installed. In the short run, therefore, an attempt to correct a supply imbalance by cutting aggregate demand and/or by switching consumption away from imports and exportables is likely to lower output in non-tradeables sectors without triggering a commensurate increase in the output of the foreign trade sector, thereby generating an unnecessary loss of real income.

16. The correct line of attack would be to expand productive capacity in the foreign trade sectors, while compressing demand for non-tradeables by no more than is critical from the standpoint of increasing exports. The amount of reduction in aggregate demand required to achieve a given reduction in external imbalance is often very high - especially if existing domestic market orientated production cannot, in principle, be switched to exports. Indeed such demand cuts, if concentrated on farmer incomes (directly or by cutting production of basic consumer manufactures), on government spending for maintenance of infrastructure and for basic health and education services and on low-income urban groups (e.g. via instant abolition of food subsidies and minimum wage freezes), are likely to erode even export oriented production. They would tend to create a pseudo-equilibrium sustainable only at steadily falling real output, deteriorating capital stock and increasing levels of socio-political tension. To avert this pattern of disintegration requires more initial period maintenance (or augmentation)

of import capacity to sustain or rehabilitate maintenance and capacity utilization as well as to enhance export capacity directly. This, in turn, implies moderating the pace at which the external balance is corrected: investments will need to be phased over a period of years, and each will take time to yield results. Thus, the appropriate blend of adjustment and financing is likely initially to involve slower adjustment and greater financing when the imbalance is the result of deterioration in the terms of trade, than when it results from an over-expansion of demand.

17. The speed of adjustment via supply enlargement will depend to an important degree on the rate and sectoral composition of new investment. Incentives of various kinds can help reallocate resources to the activities warranting expansion. But much less can be expected from price signals where the volume of new investment is low than where it is high; and demand reduction, inasmuch as it reduces savings, is likely to make the task of increasing investment more rather than less difficult. Successful adjustment to a deterioration in the terms of trade will therefore require not only the avoidance of unduly restrictive (or expansionary) policies regarding demand, but also a rise in the level of new investment.

18. When the capacity to save and the availability of foreign exchange have been impaired by a worsening of the terms of trade, it will be particularly difficult to increase investment solely through domestic efforts. Indeed, in such circumstances, a rise in the propensity to save might well result in cuts in output and employment, rather than a diversion of income from consumption to investment. An adjustment process that took this route could be expected to result in not only unnecessarily high losses in current income, but also losses in terms of future income due to failure to bring about the structural changes necessary to sustain growth and development. What is needed is an increase in the flow of external financing, in conjunction with an increase in domestic savings, to enable the necessary expansion of productive capacity to take place, and do so without disrupting the economy as a whole. Payments financing thus needs to be underpinned by external assistance on appropriate terms and conditions.

19. Maintenance and utilization of existing productive capacity are critical in low-income countries for several reasons. First is the extreme damage done by reduction in already inadequate levels of personal consumption and basic public service availability. Second is the negative effect on structural adjustment of deterioration of the infrastructure resulting from extended payments crises. Third is the negative impact of the existence of underutilized productive capacity on domestic savings, investment incentives and overall economic policy formulation. Fourth, the falls in production - particularly in manufacturing - and imports frequently cause a radical erosion of the tax base thus causing or exacerbating recurrent budget deficits despite real expenditure cuts. Fifth, by reducing supplies of inputs (e.g. fertilizers, implements) and supporting services (e.g. transport) the cuts in production erode both export and domestic food production and increase losses prior to export or consumption - worsening both the

external balance and food supply position. Sixth, by curtailing availability of domestically produced basic consumer goods - especially in rural areas - such cuts in production reduce incentives for producing agricultural products for sale, thus reducing, not increasing, supply of exportables and import substitutes. In extreme cases - of which at least a score now exist, mostly but not wholly in Sub-Saharan Africa - maintenance and capacity utilization support is more critical than most new investment projects because the latter only add to future underutilized capacity while the former can enhance present and short term future supply of exportables and import substitutes as well as averting increases in absolute poverty, malnutrition and government deficits.

20. The preceding discussion also carries implications regarding the use of the exchange rate as an instrument of adjustment. Devaluations may be necessary to correct a divergence between domestic and foreign rates of inflation, and in order to guide new investment into the right sectors. But devaluation should not be expected to generate a quick turn-around in the current balance by itself (or even in combination with demand restriction), if export expansion and import substitution are contingent upon new investment. In certain situations, controls and other selective measures may be more suitable.

21. To conclude, successful adjustment to worsened terms of trade requires an expansion of investment rather than a contraction of demand; otherwise the underlying disequilibrium will be suppressed rather than corrected, resulting in damage to the development process without removing the prospect of renewed payments pressures in the future. Adjustment through growth implies a need for time to make the adjustment - and hence, bridging finance - as well as additional capacities - and, hence, long term resources from abroad. Both need to be assured for a number of years ahead to allow forward planning.

22. Since the process of payments adjustment to a worsened external environment involves issues related to the pace and pattern of development, it is inappropriate to draw a tight distinction between payment support on the one hand, and development assistance on the other. The amount of payments support required, the period of time over which it will be necessary, and the policy measures called for will depend on the structure of the economy in relation to the size and origin of the payments deficit. Equally, the extent, form and timing of the investment resources needed will depend on the size and type of balance of payments adjustment appropriate to the situation.

### The international response

23. The increased payments pressures on developing countries have been eased to some extent by the international community. However, so far the response has proved to be inadequate. Indeed, on the whole, it has been less positive than in the 1974-1975 period when, as now, external factors pushed the external accounts of many developing countries into a large imbalance.



24. The IMF has adopted a number of policy changes in the past several years that in principle enable it to provide a more significant share of the balance of payments financing required by developing countries than in the past.

25. The Seventh General Review of Quotas was implemented at the end of 1980, which raised quotas by an average of 50 per cent and thereby increased borrowing ability; and preparatory work on the Eighth General Review was initiated in 1980. Moreover, in August 1979, the quota limit for borrowing from the Compensatory Financing Facility (CFF) was raised from 75 to 100 per cent, and the annual borrowing limit of 50 per cent of quotas was dropped. In 1981 the facility was extended to cover the cost of excesses in cereals imports above trend averages and the maximum drawings outstanding on combined export shortfalls and cereals excesses raised to 125 per cent of quota. The most notable steps taken by the Fund, however, have been to raise the limit to drawings under quota to 150 per cent a year, with a maximum limit of 450 per cent over a three-year period, and a maximum limit or cumulative access to Fund resources, net of repurchases or repayments, of 600 per cent of quota.

26. The Fund has also adopted a new set of guidelines on conditionality whereby, among other things, stand-by arrangements may be concluded for a period of up to three years in order to alleviate the effect of corrective measures on real incomes and to contribute to a distribution of the burden of adjustment within the economy that is socially and politically more acceptable. The guidelines also state that in assisting countries in the design of adjustment policies, the Fund will pay due regard to the concern of countries about the compatibility of stabilization policies with their economic priorities and their domestic, social and political objectives.

27. However, the stated modifications in Fund policies, and especially in actual Fund practices, have not reflected adequately the extent and gravity of the payments pressures upon developing countries, particularly the low-income and structurally disadvantaged countries.

28. The enlargement of quotas has been very modest; indeed it was not enough to improve, other than to a very small degree, the ratio of quotas to trade, which is low by historical standards. The substantial increase in the multiple of quotas that can be drawn cannot be regarded as a satisfactory alternative to quota increases inasmuch as it involves a lowering of the proportion of borrowing limits carrying first credit tranche conditions; if quotas had been increased by sixfold in place of the rise in the multiple to 600 per cent of quota - which would have been the normal way of proceeding - first-credit tranche conditionality would have applied to the equivalent of 150 per cent of current quotas instead of 25 per cent. The increase in the proportion of quotas that can be drawn under the CFF must also be set against the modest rise in quotas. Moreover, drawings to cover cereal-related deficits are only marginally additional to other CFF drawings - the ceiling on CFF drawings has been raised from 100 per cent to 125 per cent of quota - nor are import price rises other than for cereals taken into account.



The ratio of deficit developing countries IMF quotas to exports stood at 16 per cent over 1966-68 and declined to 6 per cent over 1979-81 while that to current account deficits declined from 64 per cent to 12 per cent over the same period. Thus the increase in CFF limits in proportion to quotas (from 50 per cent in 1966 to 125 per cent in 1981) has not even maintained real value in respect to exports while in respect to current account deficits it has been halved. Further in 1979 the IMF altered the calculation of shortfalls from an arithmetic to a geometric average centred on the year in respect to which the CFF drawing is sought. As the IMF itself stated the result of this alteration was to reduce the amount of shortfall as calculated for CFF purposes. Thus, not only has there been no addition to low-conditionality resources comparable to oil facilities established in 1974 to meet the externally generated deficits arising from the first jump in oil prices, there has been a shift towards more conditional borrowing for drawing under quota. In particular, CFF drawings have sometimes been handled together with higher credit tranche and EFF drawings and thus subjected to their high conditionality.

29. Moreover, the Fund has not accepted the principle that externally generated deficits need to be remedied differently from those resulting from excessive expenditure. On the whole, the Fund continues to seek to remedy deficits through demand reduction, and to the extent that supply is addressed, the focus is on the freeing of market forces rather than on increasing investment, still less on achieving higher utilization or enhanced maintenance of existing productive capacity. Although it has for some years allowed, under the EFF, drawings with repayment periods of longer than the normal 3 to 5 years, it continues to use performance criteria whose rationale stems from a short term and monetarist diagnosis of payments deficits rather than one based on structural characteristics. This approach does not provide a time frame adequate to achieve alterations in production structures based on selective increases in capacity to produce tradeables. Stand-by arrangements have continued to involve the setting of precise time-bound targets for the money supply and bank credit - an approach which has proved to be full of pitfalls, in both developing and developed countries - and this has been in large part responsible for the frequency with which stand-by arrangements have broken down, particularly since 1979.

30. These shortcomings are felt most by the low-income, structurally disadvantaged countries since, as we have already pointed out, for them the Fund is the lender of first as well as last resort. The stringency of Fund conditionality in the past led many developing countries to avoid recourse to the Fund, especially since their borrowing limits were not large. However, payments pressures have now reached the point at which recourse to the Fund cannot be easily avoided: credit tranche and EFF drawing rose from \$ 0.12 billion in 1980 to \$ 5.78 billion in 1981. Drastic curtailments in development programmes increasingly have been rendered unavoidable. In part, this is due to the very high incidence of breakdowns and suspensions in agreements entered into since 1979 as the Fund shifted towards tighter terms.

31. For the low-income countries, the paucity of action with regard to

the terms of IMF lending is also a matter of concern. The Subsidy Account has received relatively modest contributions from members, and the Trust Fund monies - which constitute the principal resources for the Subsidy Account - involve no additionality: nevertheless, the users are subject to higher conditionality. Moreover, no subsidy account has been established for the Enlarged Access Facility, although the considerations justifying a subsidy in the case of the Supplementary Financing Facility are fully applicable to its successor.

32. In May 1982, the Ministers of the Group of Twenty-Four "expressed serious concern at the hardening of the Fund conditionality and the growing number of inoperative programs". Almost all of the latter were occurring in low-income countries experiencing difficulty in meeting Fund performance requirements under conditions of deepening international recession affecting their export earnings. The Ministers "regretted the emphasis on demand management policies and the limited role assigned to policies to enhance supply and to address structural imbalances, which give Fund programs an essentially deflationary character that is not appropriate to the structural nature of the problems faced by most developing countries or to the conditions of the world economy". They called for a greater role for the Fund in the recycling and adjustment process "through appropriate conditionality".

33. Low-income developing countries have received little relief from SDR allocations. This may be gauged by the fact that total allocations were some \$ 4 billion per annum for the third basic period (1 January 1978 - 31 December 1981) of which energy-importing developing countries received less than \$ 750 million.

34. Long-term assistance flows have risen, but by much less than the financing requirements of developing countries. Some bilateral donors have raised their transfers significantly; however, some major developed countries have opted to reduce their aid appropriations. Assistance from OPEC member countries has continued to increase, and the proportion of GNP accounted for by aid continues to stand several times higher for OPEC donor countries than for the developed market economies. However, since 1978, this growth has not been sustained. This is hardly surprising given the unsatisfactory balance of payments position confronting all but a handful of oil-exporting developing countries as of 1982.

35. The response of the multilateral institutions has been positive, but, again, modest in its proportions. The IBRD's capital base has been increased by a moderate degree. IDA, on the other hand, is making cut-backs owing to reductions in contributions below the levels agreed for the Sixth Replenishment. IDA commitments in fiscal year 1982 were \$ 2.7 billion, substantially below the levels of the last few years, (\$ 2.3 billion in 1978, \$ 3.0 billion in 1979, \$ 3.8 billion in 1980 and \$ 3.5 billion in 1981), especially in real terms. IDA lending because of its low cost is particularly critical to low-income countries, especially at a time when even semi-concessional rates (e.g. export credit, World Bank) are at or above 10 per cent, so that these reductions have a

disproportionately severe impact on their ability to procure foreign resources at a bearable cost.

36. The Bank has adopted a policy of providing "structural adjustment loans" - programme assistance in order to facilitate fundamental adjustments designed to correct an underlying payments deficit. Here again, however, there is no additionality of resources. This new approach can, nevertheless, benefit countries with structural payments deficits, since these loans are fungible, though conditional. It is too early to judge the Bank's new lending policy, but the evidence would suggest the need for a more coherent, uniform and stable Bank perspective on what the scope of adjustment should be. In particular inadequate attention appears to be being given to the need to sustain basic consumption and service levels and to realistic estimates of the time lags between approval of programmes, disbursement of funds and achievement of actual increases in investment and output. Further, the imposition of macro and sectoral policy conditionality additional to that of the IMF whatever its logical rationale seems likely to constrain resource allocation in low-income countries to the point of creating a serious new set of semi-structural rigidities and resource utilization inefficiencies.

37. While the regional development banks have not been active in adjustment finance, bilateral donors (such as the European Community) have extended payments support (and food aid) in significant amounts. Such aid has however not always been adequately co-ordinated with national adjustment strategies, perhaps because long-term payments support has been generally regarded as a special ad hoc measure, rather than as a more general element in low-income country programmes, at least for the duration of the present economic crisis.

38. Despite the many developments that have taken place, therefore, concessional and other official aid flows have been sluggish and overwhelmingly project-oriented, at a time when low-income countries are encountering great difficulty in maintaining import levels, and when the over-riding objective for many recipients is to maintain capacity utilization.

### Recommendations

39. The Group agreed on a series of recommendations designed to assist low-income countries in coping with their present economic crises - internal as well as external - and with achieving structural reduction of these imbalances through special measures oriented to increased investment in, and production of, exports and import substitutes. While these measures are equally applicable to the developing countries in general, they are, in the present context, perceived as of special relevance to the low-income, structurally disadvantaged countries for four interconnected reasons:

- (a) These groups of countries suffer from structural rigidities



that severely constrain their ability to mobilize internal resources as a means of propelling their economies from the present poverty trap level;

(b) These economies are particularly dependent on access to public sector resource transfers because of their lack of effective access to commercial bank borrowing;

(c) The need for external resources - relative to required adjustment and to GDP - is greater for low-income countries because of the relative openness of their economies and their lack of margins of domestic resources above normal minimum operating requirements; and

(d) Certain programmes e.g. compensatory finance and other special facilities - are relatively most important to those economies with high ratios of trade to GNP and volatilities of terms of trade.

40. These recommendations are intended as sui generis treatment for the structurally disadvantaged low-income countries in their relations with the international monetary system. Their external imbalance crises and structural constraints must be alleviated now through the international financial system. To that end, the measures proposed are ones which could be adopted within the existing system without awaiting long term structural reforms. They do not constitute an alternative to such reforms but, rather, interim action needed urgently to avert a series of national economic collapses pending world economic recovery and the negotiation of longer term structural reforms.

#### A. Recommendations relating to IMF

In relation to the IMF the Group agreed on the need for action on a number of issues with specific reference to additionality of resources, conditionality and the general operational philosophy of the Fund. These are intended to enable the LICs to participate more meaningfully in the International Monetary System. Accordingly, the Group agreed to the following recommendations:

1. The Eighth General Review of Quota should at least double IMF quotas. In view of the pressures which have arisen since the Seventh General Review of Quota, it is urgent to accelerate the time period for the Eighth Review. In setting quota levels special consideration should be given to lack of effective access to commercial credit sources as a factor justifying larger relative quota increases for low-income countries.

2. The compensatory financing facility (CFF) should be untied from quota limitations and related to shortfall of export earnings calculated in terms of import purchasing power, i.e., it should compensate for loss of earned import capacity. Shortfalls should be calculated on an arithmetic, not a geometric, average thus reverting to the pre-1979



basis. <sup>1/</sup> Repurchase schedules should be linked with recovery of export earnings in terms of real import capacity. Provision already exists for accelerated repurchases in cases of rapid export recovery - a comparable set of provisions should be made for deferred repurchases (perhaps over years 5 to 10 following the year of drawing) in cases of continued real export shortfalls. The CFF should remain a low conditionality facility in respect of all drawings and not be repackaged with upper credit tranche, EFF and other high conditionality drawings and thereby subjected to their conditions.

3. The Extended Fund Facility (EFF) should be made more need related in terms of eligibility, preferably by untying it from country quotas, but alternatively by more frequent use of waiver powers in respect to quota limits. The conditions accompanying drawings should place greater weight on achieving higher real output and maintenance both of real household incomes and of basic public service provision levels, and less on particular domestic policy measures chosen for use in regaining international balance. Because "trigger clause" targets are calculated on specific assumptions as to world economic variables (e.g. interest rates, export and import prices) and of domestic events not totally within state control (e.g. crop output, inflation rates), the targets should be subject to automatic adjustment on agreed formula bases if the actual levels of these variables diverge widely from those assumed at the time of programme agreement.

4. A special window should be set up as an emergency facility with, say, \$ 2 billion a year for five years to provide additional resources to the low-income countries facing severe adjustment problems and with inadequate access to financial markets. Drawings under this facility should be concessional, not quota-linked and should be eligible for interest rate subsidy from Subsidy Account resources. Drawings should carry relatively long repayment schedules with provision for deferral of repurchases at least 5 to 10 years following drawing in cases of continued real import capacity shortfalls below pre-crisis levels.

5. The subsidy account should be topped up to cover additional subsidy requirements under additional drawings resulting from proposals 1 and 3. Eligibility for such subsidies should be extended to include all structurally disadvantaged developing countries.

6. A substantial new issue of SDRs should be made over 1983-1985. SDRs should be linked to development finance. Allocations should be

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<sup>1/</sup> The IMF justification for use of a geometric mean, that over 1975-78 global trade had grown on a geometric trend, was not, in fact, the experience of most low-income countries even then and does not correspond either to their or to global trade's evolution over 1978-1982.

delinked from quotas and related to structural trade account deficits.

7. In formulating conditionality the IMF should define conditionality in a way more favourable to the needs of LICs. Differentiated treatment which recognizes the differential burden of conditionality, rather than a uniform approach should be adopted as a more equitable way of dealing with LICs problems. In its operating philosophy, the IMF should take cognisance of the basic structural differences between the industrial countries and developing countries and in particular the LICs. It should recognize the dominance of exogenous factors in the present crisis confronting LICs. It should put the stress on supply extension through new investments rather than on demand contraction, and adopt a more flexible approach regarding particular adjustment measures chosen by drawing states. In this respect, it should recognize that forcing adjustment in the external account before adjustments in the productive capacity have taken place, entails severe costs in terms of output and employment. The IMF should, therefore, support programmes that involve import reductions and export expansion through the growth of supply.

B. Recommendations relating to the World Bank Group

8. The capacity of the World Bank Group to mobilize resources for lending to developing countries is of particular importance to the low-income countries. The regular lending programme of the World Bank envisages total lending of \$ 60 billion over the 5-year period ending in fiscal year 1986, a figure that implies no expansion in real terms over the period. These plans should be revised so as to allow for an expansion of regular bank lending of 5 per cent per annum in real terms over the next several years.

9. The modalities of Bank lending should be modified considerably so as to adapt them to the present needs of developing countries. The proportion of structural adjustment loans in total lending should be increased to at least 30 per cent and the conditionality attached to the structural adjustment loans modified. Particular attention needs to be given to achieving a positive growth rate of real GDP while improving the structural balance between exports and imports. Such lending should widen key structural bottlenecks while attaining high levels of capacity utilization. It should also maintain and expand basic services without entailing worsened income distribution and without increasing the numbers suffering from absolute poverty.

10. As regards regular project lending by the World Bank, attention should be given to projects likely to have a direct impact on the balance of payments. In the light of the financial difficulties currently being faced by low-income and other developing countries, there is need to increase the proportion of total project costs financed by the World Bank; in particular there should be greater World Bank financing of local costs.

11. Because the IDA is the single largest multilateral source of concessional funds for structural adjustment available to structurally disadvantaged developing countries, it is crucial that this source of financing should be expanded in the years to come. The special arrangements for fiscal year 1984 need to be finalized in a way that maximizes IDA flows in that year. Negotiations on IDA-VII need to result in a substantial real increase in IDA resources.

C. Recommendation relating to Regional Development Banks

12. Regional development banks should increase both the shares of soft window and programme lending in their total disbursements and the real levels of such lending.

D. Recommendations relating to ECDC

13. Developing countries' central banks should explore the possibilities for increasing use of deposits with one another as a means to bolstering the ability of these countries, and particularly structurally disadvantaged developing countries, to withstand crisis-related shocks.

14. Developing countries in a position to do so should create or expand regional soft loan funds open to use by structurally disadvantaged developing countries possibly along the lines of the Nigerian fund administered by the African Development Bank and/or of Trinidad and Tobago in respect to CARICOM.

15. Surplus oil exporting developing countries should broaden the availability of loan back arrangements of a portion of the price of petroleum and products exports to structurally disadvantaged developing countries possibly along the lines of the programmes now carried out by Mexico, Venezuela, Trinidad and Tobago and Nigeria.

16. National and multinational development institutions financed by oil-exporting developing countries should alter the balance of use of the resources available to them toward a greater proportion of balance of payments support soft loans and grants and toward sectoral soft loans keyed to supporting maintenance and capacity utilization in key sectors to low-income countries with particularly severe external balance problems. Such a reallocation to improve effectiveness of programmes in meeting low-income economy crises through maintaining productive capacity and enhancing supply is particularly important now that the external balance position of most oil exporting countries precludes substantial increases in their volume of resource transfers.

E. Recommendations to bilateral sources of finance

17. The aid effort of developed donor countries should be intensified. Bilateral donors should seek to adapt their aid programmes to low-income countries to the present circumstances. Among other things, this would entail increasing substantially the volume of budgetary and balance of payments support at least for the duration of the present economic crisis.

18. The terms of industrial economy guaranteed export credits to structurally disadvantaged developing countries should not be hardened in respect to interest rates and both the maximum grace and repayment periods should be lengthened - say to 3 and 12 years respectively. Industrialized countries should take a more responsible attitude in not promoting such credits where they are an unsuitable source of finance (either because of the nature of the project, or the medium term external balance prospects of the economy) and by acting to ease terms on outstanding credits of this type which are creating, or may create, debt service crises for developing countries and in particular structurally disadvantaged developing countries.

19. Governments should give urgent consideration to providing external borrowing guarantees to presently structurally disadvantaged developing countries for commercial borrowings, with special reference to those countries which have in the past had access to, and ability to service, such borrowings, but have temporarily been pushed into the structurally disadvantaged category by post 1979 external shocks.





## THE NATURE AND DIRECTION OF INTERNATIONAL MONETARY REFORM

Ariel Buira\*

### I. Introduction

1. Recent years have seen substantial changes take place in the world economic environment. In particular, there has been a virtual stagnation of world trade, a steady emergence of structural disequilibria and an unprecedented level of interdependence among national economies. At the same time, the developing nations have become a more important economic and political force in the world. The structure created at Bretton Woods in 1945, despite partial reforms, has failed to adapt fully to such changes. As a result, the difficulties in the world economy have been needlessly aggravated.

2. The present world economic situation and the uncertain prospects for the coming years make a reform of the international monetary system necessary. The developing countries have already examined many of the aspects of this issue, in particular through the work of the Group of Twenty-Four, and though some progress has been made, few fundamental changes have taken place. However, if the international monetary system is to contribute to the equitable and sustained growth of the world economy, a number of key issues will have to be addressed.

### II. The Changing Nature of the Adjustment Process

3. Economic disequilibria during the 1950s and 1960s were usually the result of excessively expansionary domestic policies. The typical case was that of an ambitious development programme financed through a growing public-sector deficit. Economic adjustment of such disequilibria obviously had to centre on the control of demand and the re-establishment of fiscal discipline. The causes and the characteristics of economic imbalances, however, have evolved substantially during the past decade, changing the nature and the requirements of the international adjustment process.

4. In the last ten years, economic policy-making in all countries has confronted new difficulties. Firstly, the economic environment has been plagued by the emergence of structural difficulties often closely related to huge changes in the relative prices of traded goods, including energy, and by record levels of interest rates in the

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international financial markets. Secondly, the pace of world economic expansion and the growth of world trade have declined substantially - a situation that will probably persist in the medium term. Finally, the conduct of economic policy has faced the constraints imposed upon it by an unprecedented level of world economic integration.

5. The above-mentioned factors have significant implications for economic adjustment. In the 1950s and 1960s, in countries where traditional adjustment programmes were developed, they often entailed no more than slower growth of domestic consumption, since a devaluation and mild demand-dampening measures were enough to switch resources to exports while keeping the economy at near full employment. This is no longer the case: world trade is too depressed. The protracted recession and the stagnation of world trade give rise to significant difficulties in the implementation of economic adjustment. In addition, the structural nature of numerous economic problems makes the traditional approaches to the process of adjustment incomplete or inappropriate. In present circumstances, it is clearly preferable to restore equilibrium through a combination of policies aimed not only at reducing or eliminating excess demand, but at stimulating production and investment in certain strategic sectors so as to restore economic growth. Structural changes must be supported by policies that go beyond mere demand management when they lead to the strengthening of the economy, even if they may not immediately reduce the payments imbalances. Exclusive reliance on policies that concentrate on restraining demand runs the risk that such policies may affect adversely the sources of economic growth and become politically unsustainable.

6. Moreover, increased international economic integration implies that the success of the economic policy followed by a country will often depend on the actions of others, so that policy decisions should be made with consideration to their impact on other countries.

7. The failure to recognize the need to adapt economic adjustment programmes to a changed economic environment has been one of the main causes of the deterioration of the world economy in recent years. Among industrial nations, the economic policy response to economic difficulties has too often been based on unbalanced policy approaches, placing undue reliance on monetary restraint measures as opposed to fiscal policy, to the solution of structural difficulties, or to the impact of such measures on the rest of the world. The adverse effects of this approach are well known: unprecedently high interest rates in the international financial markets leading to stagnation, volatility and misalignments of the major currencies, and the growth of protectionism.

8. These factors, together with the oil shocks, have had highly adverse effects on the non-oil developing countries. In recent years, these countries registered a very large increase in their payments disequilibria, generated mostly by external factors. <sup>1/</sup> Such difficulties have been substantially accentuated by the marked asymmetry that has characterized the international adjustment process, i.e. the

burden of adjustment has come to rest on deficit developing countries with little corresponding action on the part of the surplus countries. In an effort to sustain economic growth under adverse external conditions, non-oil developing countries have increased sharply their external indebtedness. Nevertheless, the growth of total output of the group has decelerated dramatically and, as a result of the high levels of external indebtedness, fears have arisen with respect to the creditworthiness of major borrowers and the stability of the international financial system.

9. Overcoming the present difficulties of the world economy would be facilitated by a greater degree of policy co-ordination and the framing of national economic policies by major countries within an international framework and by the adoption of measures specifically aimed at the solution of structural rigidities and imbalances. The recent UNCTAD proposal concerning a global economic recovery programme - comprising both developed and developing countries - takes on great relevance in this context.

10. The prospects for growth and external adjustment on the part of developing countries depend substantially on the evolution of economic growth in the developed countries. As a result of a combination of factors, however, the pace of expansion in the developed world over the medium term is likely to remain slower than during earlier periods. On the other hand, the structural nature of the economic adjustment needs faced by most developing countries calls for larger amounts of longer-term finance if their growth prospects are not to be seriously impaired. Consequently, the financial requirements of developing countries must be placed within the framework of the international adjustment process and recognized as a problem of the international community.

11. It is apparent that very high levels of external financing to deficit countries cannot be sustained indefinitely, and that in many cases adjustments must be effected to achieve current account deficits that are sustainable over the medium term. To the greatest extent possible the growth of trade must be seen as a preferred alternative to financing. However, the prospects for world trade expansion are not very favourable.

12. In fact, a substantial drop in developing countries' imports, frequently associated with demand restraint measures, has adverse effects on the rest of the world. This is of special relevance at present, since numerous developing countries - including those that have a significant role in world trade - 2/ are undertaking sharply deflationary adjustment programmes that may generate a substantial decrease in developing countries' imports. Since developing countries account for about 30 per cent of world imports, a decrease of developing countries' imports ranging from say 5 per cent to 10 per cent - ceteris paribus - would contract world trade by 1.5 per cent to 3 per cent, hindering the recovery of the international economy. It is therefore clear that the implementation of adjustment measures in developing countries must take appropriate consideration of world economic



integration. This calls for the adoption of policies leading to the required structural adjustment of their economies consistent with the maintenance of international trade flows.

13. The achievement of an efficient process of international adjustment requires the existence of an adequate operational framework. In fact, many of the costs involved in economic adjustment in recent years may be associated with the malfunctioning of the existing arrangements. Thus, there has emerged a growing need to modify them, so as to adapt their operation to present needs and to developments in the near future. The exchange rate system and the international financial institutions occupy a central role in this process.

### III. The Foreign Exchange Regime

14. A widely held view during the 1960s and early 1970s was that a move from fixed to flexible exchange rates would reduce interdependence and would provide greater freedom for the operation of economic policy. In spite of the widespread use of floating rates since the mid-1970s, however, international transmission of economic disturbances has continued and, in some instances, flexible exchange rates may have actually transmitted such disturbances across national boundaries more strongly than a system of mixed exchange rates.

15. Furthermore, the exchange markets have been affected since the beginning of the 1970s by substantial volatility and persistent misalignments of the exchange rates of major currencies. This development can be attributed, partly, to the differential effect among countries of the shocks on the world economy generated by the sharp changes in relative prices. However, more recently the unstable and erratic behaviour of exchange rates of some currencies seems to have been essentially a response to financial policies followed by other countries.

16. The impact of United States domestic economic policies of the exchange rates of most other currencies are a case in point. The fiscal-monetary policy mix implemented in the United States since 1979 has increased substantially the level and variability of interest rates in that country. This, combined with the fact that the United States has practically stopped intervening in the exchange markets since 1979, has had two important consequences:

- (a) The dollar has shown a sharp appreciation which has apparently caused an overvaluation of this currency, with the corresponding undervaluation of other countries. <sup>3/</sup> As a result, most major exchange rates have registered in recent years substantial and persistent misalignments, with serious adverse consequences for the world economy, since the patterns of trade and capital movements have been distorted, import prices - in domestic currency terms - of many countries have increased and economic activity has been reduced. In the

United States, the overvaluation of the dollar, by contributing to an increase in the current account deficit, has forced some industries to exert pressures on the Government to adopt protectionist measures. Thus, the misalignments of major currencies during the last few years have increased the overall rate of inflation and, at the same time, have accentuated the world recession, the stagnation of trade and the rise in protectionism.

- (b) The constant movement in interest rate differentials that has resulted from the variability of the United States interest rates and the different degrees of monetary restraint in the industrial countries have been among the main causes of the sharp fluctuations in the exchange rates of the developed countries. The costs of this variability have been quite high in recent years. Exchange-rate instability gives rise to uncertainties for investors and traders, and for the financial system itself. As a result, it has adverse effects on the allocation of resources, and hence, on overall economic efficiency.

17. Both these effects have been particularly costly to developing countries, given that they are unable to effect international transactions in their own currencies. Furthermore, since most developing countries peg their exchange rates to those of the developed countries, the movements in the external value of industrial countries' currencies are an important cause of instability in the exchange rates of developing countries, although such movements generally bear little relation to the payments situation of the developing countries.

18. The large fluctuations in the exchange rates for major currencies observed in recent years, together with their apparent lack of correspondence to underlying economic and financial conditions, have raised doubts about the functioning of the present exchange system. There is little question that a flexible currency system has certain desirable features which should not be sacrificed. But, at the same time, the advance implications of excessive short-run turbulence in the exchange markets and the possibility of overshooting are sufficiently serious to raise the question whether exchange rates are too flexible at present.

19. The restoration of fixed exchange rates would be difficult because of present discrepancies in inflation and growth rates among industrial countries. One way of obtaining a limited degree of exchange rate flexibility is through the adoption of intervention rules. The adoption of target zones - with a relatively wide range within which rates might be allowed to move - and an approach based on co-ordinated intervention by the authorities of several countries, would be a way of strengthening the exchange-rate system. This approach would have the advantage of fighting disorderly conditions in the exchange markets, ease the movements in the exchange rates and, on occasions, correct an exchange rate considered inappropriate.

20. Intervention is an effective means by which exchange rates may be influenced in the short run. However, experience has shown that attempts to pursue exchange objectives that are inconsistent with fundamental economic forces tend to be self-defeating. Exchange rate targets without the support of an accompanying economic programme can hardly be expected to be effective, since it is in the underlying economic conditions that the key to exchange stability is to be found.

21. The effective functioning of the exchange rate system requires the recognition by major countries that both fixed-rate and floating-rate regimes need rules of the game relating to domestic macroeconomic policies. The preceding arguments suggest that reliance on the role of the exchange rate should be lessened to a certain extent, and greater emphasis should be placed on the convergence of economic performance. Obviously, this implies the search of means by which a substantial degree of discipline and co-ordination in the conduct of national policies can be achieved. One such means may be the strengthening of multilateral surveillance by IMF on the economic policies of member countries.

#### IV. Surveillance by IMF

22. A fundamental responsibility of the IMF is to promote the consistency of member countries' exchange-rate and related policies with an orderly and co-operative external adjustment. In principle, the exercise of this surveillance function has focussed on: (a) the need for a balanced policy approach, to counter inflation and inflationary expectations, with monetary policy being adequately supported by fiscal policy; (b) the importance of issues concerning the appropriate scale of intervention to counteract disorderly conditions in exchange markets; (c) the ensuring that exchange-rate policy is not used to secure inappropriate competitive advantage; (d) the promotion of resistance to protectionist pressures; and (e) the improvement of information and analysis in the field of external debt. <sup>4/</sup> In practice, however, serious flaws have been observed in the implementation of surveillance by the IMF.

23. The economic policies of the industrial countries, especially in the largest among them, have far-reaching effects on the international economy because of the key position they occupy in the system as a whole. Therefore, surveillance by the Fund should focus primarily on these countries. A review of the poor economic performance of the world economy since the 1970s and of the reasons behind such performance, including the unbalanced fiscal-monetary policy mix implemented by some countries, suggests that the Fund has been unable to perform that function efficiently.

24. The lack of political willingness on the part of some of the major industrial countries to pursue policies that are consistent with the requirements of the international economy has been a major factor in the poor performance of the world economy in recent years.



25. A logical result of the above situation has been that, in general, the IMF has been unable to exert significant influence on the direction of its members' economic policies, except in those cases where countries have requested access to its resources. Thus, IMF has focused its attention and has been able to exert effective pressure only on the users of its resources - i.e. developing countries with balance-of-payments deficits. In the process, a fundamental asymmetry has been introduced in the Fund's surveillance function and the international adjustment process has become seriously biased.

26. The major biases are: (a) the current-account imbalances of major reserve currency countries have not been subject to the same discipline as deficits of other countries; (b) the existence of structural balance-of-payments deficits and surpluses, as well as their interconnection, has been largely ignored; (c) the existence of a "natural" tendency to adjust by deficit countries and the absence of effective surveillance of the surplus countries, have placed the burden of adjustment on deficit countries, mainly developing countries. As a result, the deficit countries have been faced with shorter periods and harder adjustments and the world economy with a lower level of activity than would otherwise be necessary.

27. A reformed international monetary system should include an effective, symmetrical and equitable adjustment process. In order to ensure effective application of these principles, in supervising the exchange-rate and related policies, the IMF must give equitable and symmetrical treatment to all countries, surplus and deficit, to ensure that countries with surpluses and those with reserve currencies accept an equitable part of the burden of adjustment.

28. In particular, the Fund's surveillance must provide guidance for the design of national economic policies, especially within the developed world, so that they contribute to the achievement of the objectives of the international economy as a whole. Such objectives should be set on the basis of the periodical diagnosis of the international economic situation by the IMF. In this process, surveillance by the Fund must adopt a dynamic perspective, taking into account both the current situation and the requirements for world economic growth and a fuller use of resources. At the same time, in exercising its surveillance function, the Fund should give proper consideration to structural difficulties and to the high degree of interdependence of national economies.

#### V. External Indebtedness of the Developing Countries and the Recycling Problem

29. External indebtedness of developing countries, mainly those in the non-oil group, showed a substantial increase during the 1970s. The pattern of this increase had three remarkable characteristics: (i) private bank lending became the single most important channel for the transfer of savings between surplus and deficit countries; (ii) the



rapid growth of debt during this period was largely accounted for by a relatively small number of countries; and (iii) bank financing flows showed a tendency to accelerate when export commodity prices were favourable and to retrench when export earnings declined. As a result of the combination of these factors, by the beginning of the 1980s the external debt situation of developing countries had registered an overall deterioration in its average term structure, and the private banking system, by concentrating portfolios on a few borrowers and tending to contract external lending at the same time as export earnings were slowing, had added a significant degree of instability to the international monetary system.

30. The external debt situation of non-oil developing countries has deteriorated sharply since 1980, as a consequence of the combined effects of the 1979/80 oil price increase, the cyclical developments of the world economy and a sharp rise in commercial loans used to finance payments deficits, at a time when market interest rates have been exceptionally high. Total outstanding debt of the non-oil developing countries is estimated to have reached \$ 612 billion in 1982, compared to \$ 130 billion and \$ 397 billion in 1973 and 1979 respectively. In relation to the group's output and exports, external indebtedness rose to record levels.

31. By the middle of 1982, intense concern arose in the private banking community regarding the ability of some of the major borrowers to meet their external commitments. As a result, it is estimated that net bank lending was cut back from more than \$ 50 billion in 1981 to some \$ 25 billion in 1982 and a further sharp drop has taken place in early 1983. This has given rise to the serious concern that inability of major borrowers to refinance maturing loans could generate a crisis of confidence affecting not only these countries, but also the lending institutions, with serious consequences for the whole international financial system.

32. The above-mentioned developments suggest that in future commercial banks will not be able to continue to perform the role of major financial intermediaries in the recycling of funds from surplus to deficit countries as they have done in the recent past. At the same time, the elements of instability that this pattern of recycling has introduced into the international monetary system have generated serious doubts about the desirability of its continuation. Consequently, there is now a need to design new financial mechanisms for recycling or, what may be simpler, to expand and modify the existing financial institutions such as IMF and the World Bank so that they can play a much larger role in this process.

33. The role international financial institutions should play in the recycling of funds to developing countries is twofold. In the short run, the issue is to ensure that financial flows to countries with serious debt or liquidity problems continue at an appropriate rate. The objectives would be to avoid a liquidity crisis that could force these countries to suspend debt payments and, at the same time, allow them to

undertake an orderly adjustment process that does not place unbearable strains on their economic and social framework. In addition, in the event of a crisis, these institutions could act as lenders of last resort in the international monetary system. Indeed, these roles should be fulfilled by IMF. However, Fund resources at present levels are clearly insufficient to allow it to play this role to the extent required.

34. The recent experience of countries which have faced liquidity crises and resorted to the Bank for International Settlements (BIS) shows that when rapid financial support is needed the Fund cannot provide it under existing policies. Since there is no certainty that the BIS will in future assist non-BIS countries, the Fund should modify its policies on drawings to permit large drawings to be made at very short notice. The need to establish a new facility, which had been informally considered in the past in connexion with problems caused by capital flight, should be recognized in the light of current problems. 5/

35. However, even if a liquidity crisis is avoided in the short run, a second issue still remains for the medium and long-terms, that of appropriate development financing. Present problems arise to a considerable extent from an absence of adequate sources of development finance, which has forced developing countries to resort to short and medium-term financing from international capital markets. It is apparent that continued reliance on medium and short-term financing is bound to give rise to liquidity problems in the medium term for countries that rely heavily upon it, even if the financing is all destined to sound projects.

36. The situation is currently even more serious, since payments on a large proportion of the external debt of developing countries will be falling due in the medium term. Therefore, if no additional measures are taken, recent debt rescheduling agreements - which have provided short-run solutions - could through the bunching of maturities compound the external debt problems of the developing countries in the near future. Unless capital flows to developing countries are restored, a new liquidity crisis is likely to emerge in a few years' time as the grace periods come to an end. Were this not the case, the fulfillment of debt payment commitments would turn developing countries into capital exporters, an absurd result, with substantial adverse effects on their economies and, probably, on the stability of the international monetary system.

37. In this context, it is evident that the solution to present debt difficulties requires securing sufficient financial flows to developing countries on longer maturities and that the debt problem cannot be separated from the issue of development finance. The solution of these problems will be one of the major challenges for the world economy in the 1980s.

38. Since it is unlikely that the capital markets by themselves will

satisfy such needs, the solution could lie in enlarging the resources of multilateral institutions such as the World Bank and the regional development banks, so as to permit them to recover the relative position they held in the 1960s. This solution requires the co-operation of industrial countries in raising their contributions to the capital base of these institutions. Alternative approaches would rely on the provision of government guarantees. One possibility would be the creation of a multilateral fund that would operate on commercial lines, obtaining long-term credits in domestic and international markets; the fund would grant long-term financing to developing countries for investment projects and for the purchase of capital goods. 6/ An alternative approach could be the provision of guarantees by government agencies - such as export insurance agencies - of capital exporting countries to loans extended to developing countries.

39. But no matter how substantial an increase in the resources of international financial institutions may be obtained, it will still be necessary for the commercial banks to continue to play an important role. The resources of multilateral institutions should be seen as complementary to and supportive of financial flows on commercial terms rather than competitive with them. Equally important will be the adoption of co-operative attitudes on the part of the private banking community and the authorities of creditor countries, to reschedule debt service payments and to refinance important amounts of short-term debt on longer maturities. Obviously, the solution of the external debt problems of developing countries requires a strengthening of their economies so as to achieve adequate balance-of-payments positions. This calls for the adoption of appropriate adjustment programmes and, therefore, a thorough review of Fund conditionality.

#### VI. IMF Conditionality

40. It is useful to recall that in the Fund's approach, an excessive or unsustainable expansion of aggregate demand, together with an assumed stable aggregate supply function, are seen as the major causes of economic imbalances. Fund approaches to adjustment, therefore, aim at correcting economic disequilibria mainly through the management of demand over the short run, without paying adequate attention to the supply side of the economy. This may be the correct approach in a number of cases, but not necessarily appropriate when imbalances are of a structural nature.

41. As a result, IMF stabilization programmes have certain characteristics: (a) the economic models out of which policy actions and recommendations are drawn are highly demand-oriented; (b) the main objective of Fund programmes is to reach a sustainable external position in a short period of time essentially through the manipulation of rigid credit targets; (c) the analytical framework used to formulate financial programmes usually excludes the systematic treatment of devaluations; and (d) conditionality is applied even in cases where it is explicitly acknowledged that economic difficulties are a result of external factors.



42. Traditionally, the primary goal of Fund-supported adjustment programmes has been to correct external disequilibria. The absolute priority given to the external sector may make more sense from the point of view of foreign creditors, than from that of the authorities of the countries having to implement the programmes, whose economic policy objectives are normally much broader. Furthermore, the central relationship of the Fund's approach to adjustment is that of relating the rate of domestic credit expansion to a "viable" or "sustainable" balance-of-payments target. Under these circumstances, there emerges a sharp contrast between the uncertainties surrounding the estimate of a sustainable balance-of-payments position and the precise and rigid targets for domestic credit expansion used in Fund programmes.

43. On the other hand, the length of the adjustment period needed to achieve a sustainable balance-of-payments position need not coincide with the extremely short life of Fund programmes. At least as far as developing countries are concerned, there are very sound arguments for believing that in a number of cases, particularly those involving structural imbalances, a gradual adjustment process may be more effective than a "shock treatment" concentrated excessively in the short run. This also gives rise to concern about the costs of alternative paths of adjustment. However, the Fund does not provide relevant data to assess the advantages and disadvantages of alternative adjustment paths.

44. The Fund's stabilization packages lack an analytical framework integrating the relationship between the exchange rate and the monetary and real sectors of the economy, whereby questions on the size and the optimal pace of devaluation can be answered. In addition, a questionable assumption underlying many Fund-oriented devaluations is the belief in the existence of a positive correlation between devaluation and output. There is considerable theoretical and empirical evidence suggesting that exchange rate changes in developing countries may have a substantial deflationary impact on their economies.

45. There is ample agreement regarding the external origin of many of the difficulties at present plaguing the economies of developing countries. The existing IMF Compensatory Financing Facility has as its objective the financing of temporary shortfalls in earnings - mainly of primary commodities - whose origin is due to external circumstances. Nevertheless, as a result of existing quota limits on drawings, borrowing under this Facility has remained very modest by comparison with the loss of export revenues suffered by developing countries. Furthermore, despite the explicit recognition of the external origin and the temporary nature of the export shortfalls, drawings in the upper tranche are subject to conditionality.

46. It is evident, therefore, that Fund conditionality must be adapted to the circumstances and needs of member countries in the current conditions of the world economy. In response to such requirements, the Fund's financial programmes have to give greater emphasis to the correction of structural adjustments. 7/ Supporting structural



adjustments will often require substantial investments in key sectors; these should be encouraged and endorsed to the greatest extent possible, even though they may result in higher fiscal deficits or a weakened external sector in the short run, since they will lead to a stronger balance of payments and budgetary situation in the medium term.

47. A major policy adjustment required from the Fund would be that of equating the duration and the nature of the adjustment programme to the requirements of the country. Furthermore, when designing adjustment programmes, the various possibilities available should be considered carefully in order to find the path that minimizes the costs of adjustment. In most cases, this will mean that the objective of growth must be considered on an equal footing with those of controlling inflation and restoring external equilibrium.

48. Within such a scheme, the authorities of each country would decide what combination of policies they would wish to adopt. Likewise, once a framework for an adjustment programme has been established along the above lines, the translation of this framework into an operational programme would imply the creation of a new set of performance criteria with flexibility in particular targets and substitutability or compensatory adjustments among them.

49. In this process, the resources available for the financing of payments disequilibria caused by external factors must be substantially increased, and repayment obligations must be based more on ability-to-pay principles, rather than on a fixed schedule resulting from the application of fixed schedules. At the same time, the Fund should extend low-conditionality financing facilities so as to be able to provide adequate financing when a country encounters temporary economic difficulties of an exogenous nature.

50. It is important to take into account that structural adjustment programmes could also be assisted by the World Bank and other development finance institutions. These have an advantage over the Fund in having greater expertise in the design and implementation of investment programmes, and in the fact that their loans have much longer maturities. The problem of structural adjustment is one that in most developing countries cannot be dissociated from that of development, and there is a risk that a very specialized institution will have a partial vision of the problem and follow a less than comprehensive approach to its solution. Since the distinction between balance-of-payments and development finance is not always clear in cases of structural adjustment, the re-examination of the role of existing financial institutions would seem desirable. In the meantime, the resources of both institutions would have to be enlarged significantly.

## VII. The Adequacy of IMF Resources

51. The relative size of the Fund has tended to decline over the last

20 years. Such a trend may be clearly seen by comparing the potential resources available to member countries under Fund facilities (i.e. its size), with some indicators commonly used as a proxy for the requirements of this institution's financial tasks. According to IMF staff estimates, between 1962 and 1980 the ratio of the average size of the Fund to the average sum of current account imbalances of 111 countries for which data are available fell by almost one-half. The size of the Fund has also fallen with respect to the scale of the world economy; the average ratio of the size of the Fund to imports during the seven year period 1974-1980 (3.4 per cent), was over one-third lower than the average ratio (5.5 per cent) during the preceding ten years.

52. The fall in the relative size of the Fund has been accompanied by an even more pronounced lag in the growth of quotas, traditionally the most important source of IMF funds. 8/

53. The combination of these factors has had significant consequences. On the one hand, the financing needs of countries with payments deficits have increasingly exceeded the capacity of the Fund to provide appropriate assistance from quota resources within the regular tranche structure, limiting one of the Fund's most important functions. At the same time, in meeting the financial requirements of its members, the Fund has had to depend increasingly on resources other than quota subscriptions - in particular credits - thereby generating a significant increase in the average cost of obtaining balance-of-payments assistance from this institution.

54. The problems relating to the adequate size of IMF seems to be even more serious for the coming years. On the basis of projections for the future growth of world imports and historical ratios of Fund size to world imports, IMF staff have calculated that the Fund should have a size of SDR 101 to 138 billion in 1985 and SDR 168 to 228 billion in 1990, just to return to those historical levels. Assuming no reliance on borrowing arrangements from 1985 on, 9/ such expansion would require an aggregate amount of quotas ranging from SDR 132 to 179 billion by 1985 and SDR 217 to 294 billion by 1990. 10/

55. The need to increase the size of the Fund has been widely recognized in the different groups of countries. In practice, however, this process has been considerably hindered by a lack of political will on the part of certain industrial countries. The decisions taken after the Eighth General Review of Quotas, which will have to serve the international community through much of the present decade, are a clear example of this situation. Notwithstanding the demands of the group of developing countries and the technical studies supporting the need for a much larger increase in quotas, the latter were raised to only about SDR 90 billion. There is widespread agreement that such an increase will be insufficient for IMF to meet the financial requirements of member countries with ordinary resources during the coming years. Moreover, even the possibilities of borrowing from member countries to supplement Fund resources has faced marked opposition on the part of some industrial countries. 11/

56. Another negative implication of the Eighth General Review was the resulting distribution of quotas, which affected adversely the developing countries. As a group, these countries will see a decrease in their share in the total from 38.7 per cent to 37.7 per cent; this distribution of quotas implies that, although developing countries account for more than 85 per cent of IMF members and represent the main users of Fund resources, the Executive Directors representing them exercise a little over one-third of total voting power. 12/

57. The serious imbalance between developed and developing countries in the management and control of the Fund and other international financial institutions results from the application of the principle that participation in decision-making should be proportional to each member's financial contribution. It must be acknowledged that there must be a better balance between debtor and creditor countries to keep policies and decisions from being made essentially by a single group. In fact, it may be argued that the industrial countries' own interest calls for a revision of the decision-making processes of the international financial institutions, with a view to making them more effective through increased participation of developing countries.

58. The Ministers and Governors of the Group of 10 decided in early 1983 to increase their aggregate commitments under the General Arrangements to Borrow (GAB) from SDR 6.4 billion to SDR 17 billion. They also agreed that, in the future, GAB's resources would be available also for purchases from the Fund to those members - including non-GAB participants - whose payments difficulties might endanger the international monetary system. Obviously, such modifications do not benefit all developing countries, since only the larger and more indebted among them may endanger the international financial system. It is also important to notice that the widening of GAB gives rise to some doubts about the independence of the Fund, since the Group of 10 takes part in the process of approving the loans under such agreements. In this context, it is clear that the increase of resources under the GAB must under no circumstances be considered as a substitute for an increase in quotas, and these must continue to be the main source of financing to the Fund. Of course, allocations of SDRs represent also a desirable way to increase or supplement Fund resources.

#### VIII. Allocation and Distribution of SDRs

59. In 1968, the international economic community agreed to create the SDR as one way of supplementing international liquidity and establishing control over its creation. Subsequently, in 1976, the IMF members formally agreed to make the SDR the principal international reserve asset. So far, however, the role of the SDR in the world economy has been very limited. Its role as international currency has been hindered by the fact that, as a result of the limited allocation of SDRs, its share in total international liquidity has been small and has shown a declining trend. This situation has been aggravated by some unattractive characteristics of the SDR, which have limited its use by private entities.



60. When the allocation of SDRs for 1970-1972 was decided upon, the projections made at the time implied that by the end of the allocation period SDRs would account for 16 per cent of international reserves excluding gold, and it was widely expected that thereafter SDR creation would continue to account for the bulk of reserve increases. The actual share of SDR holdings in reserves, however, rose to only about 8 per cent in 1972. Since then, the share of SDRs in reserves has shown a declining tendency - to about 6 per cent in the beginning of 1983 - and it is estimated that in the absence of a significant allocation, the SDR would continue its decline as a proportion of total reserves.

61. The limited share of SDRs in total international liquidity has been determined by the combination of several factors. As a result of the explosive growth of international liquidity in 1970-1973, the adoption of floating exchange rates of the major currencies and the growing integration of international financial markets, SDR allocations ceased to be considered by the IMF, soon after they were created, as necessary to supplement the growth of reserves in quantitative terms. <sup>13/</sup> Likewise, the severe inflationary tendencies in the world economy since the early 1970s stimulated the imposition of limits on the growth of SDRs through allocation. This effect arose from apprehension that the creation of SDRs might intensify inflation and inflationary expectations, and from the fact that in a period of rapidly rising prices the Fund considered it desirable to place emphasis on conditional lending.

62. On the basis of the above arguments, no allocations were made under the second basic period (1973-1977) and allocations were limited to an annual amount of only SDR 4 billion in 1978-1981. Moreover, the effects on inflation, inflationary expectations and the state of international liquidity have been used as elements against a new substantial allocation of SDRs.

63. Clearly, the reasoning behind such fears has serious deficiencies. In the first place, the situation of world liquidity at present differs markedly from that prevailing in the early 1970s. The average annual growth of real international liquid reserves (i.e. total reserves minus gold), which reached rates of around 40 per cent in 1970-1973, fell to a negative figure of -5 per cent during 1979-1982. It seems doubtful in these circumstances, and given the weak situation of the world economy, that an allocation of SDRs could have a significant impact, if any, on the world rate of inflation. On the contrary, world economic recovery requires an increased supply of reserves.

64. Opposition to a significant SDR allocation has also been based on the argument that the existing freedom of access to international capital markets has resulted in a highly elastic supply of reserves that permits most countries to satisfy relatively easily their foreign currency requirements. The recent contraction of net international bank lending, at a moment when there is a strong economic case for additional international reserves to deal with huge payments imbalances, does not give support to such an assertion. Furthermore, the mechanisms for



reserve creation through international private markets is based on the evaluation of each country's creditworthiness, and does not consider the global needs of the international economy.

65. In the context of a limited role of the SDR in the international monetary system, international liquidity has been determined by the policies of the reserve currency countries. As a result, year-to-year changes in international liquidity cannot be forecast and are more a reflection of the outcome of these countries' balance-of-payments policies than of the requirements of the world economy.

66. Even on the unreasonable assumption that total international liquidity is sufficient, it is clear that international reserves are badly distributed. The ratio of reserves to imports of developing countries has registered in recent years a dramatic fall, from 31 per cent in 1973 to 16 per cent in 1982 for the non-oil group. It is clear, therefore, that the distribution of liquidity in present circumstances does not take into consideration the needs of individual countries or groups of countries, especially developing countries.

67. It is urgent, therefore, to reintroduce a substantial and continued annual allocation of SDRs, in line with the requirements of the world economy and the special needs of the developing countries. <sup>14/</sup> This would represent a first and decisive step towards converting the SDR into the main international reserve asset, contributing at the same time to world economic recovery, to the stability of the foreign-exchange regime and to the alleviation of the economic problems of the developing countries. In this process, it is of primary importance to consider the distribution of the benefits of creating international liquidity among the members of the international economic community. At present, because of their larger quotas, the industrial countries receive over 60 per cent of each allocation.

68. No reasonable argument has ever been advanced to show that this distribution pattern for the benefits of SDR creation is equitable or desirable from the standpoint of the world economy as a whole. On the contrary, there are clear reasons for believing that the international reserve needs of developing countries are larger than those of the more advanced countries. For these reasons, and because of the limited flows of official development assistance, it is essential to establish a link between the creation of international liquidity and the transfer of real resources to developing countries. This objective would best be served by an increase in their share of SDRs by means of direct country allocations by the Fund. In the short run, this faces the legal restriction imposed by the Fund's Articles of Agreement. Nevertheless, such problems can be easily overcome by means of donations from the industrial countries to developing countries or to the IMF itself.

IX. Summary and Conclusions

69. The purpose of this paper has been to explore the main aspects of the international monetary system which call for reform. The topics considered comprise the requirements of the international economy and the adjustment process in present circumstances. The main conclusions of the analysis can be summarized as follows:

- (a) The adjustment process in the different groups of countries must be adapted to the present global economic environment. This implies that the design of national economic policies must give adequate consideration to the constraints imposed by a low-growth environment and the stagnation of world trade, the high degree of interdependence of the world economy and the predominance of structural disequilibria. In this context, particular attention must be given to securing adequate financial flows to developing countries, so as to permit these countries to undertake orderly and appropriate adjustment programmes.
- (b) The present exchange system must be modified, in order to attain a greater degree of exchange-rate stability at appropriate levels. In the short run, the adoption of intervention rules can make a significant contribution to this. However, since the main source of exchange movements lies in the divergent economic behaviour of countries in the long run, both the avoidance of major misalignments and exchange-rate stability rest on the convergence of economic performance. This process requires the co-ordination and harmonization of national economic policies.
- (c) The achievement of a more symmetrical and equitable international adjustment process, including the working of the exchange system, must be ensured. For this purpose, surveillance by IMF must focus much more on the major industrial countries, whose economic policies determine the evolution of the world economy. Likewise, the Fund's surveillance function must ensure that all countries - surplus and deficit - accept an equitable share of the burden of adjustment. In this context, surveillance by the Fund must be more dynamic and involve policy recommendations that contribute to world economic recovery and growth.
- (d) At a time when capital markets will not be able to play the leading role which they did in the past decade, international financial institutions and government agencies must participate more fully in the process of recycling funds to developing countries. These funds should promote adjustment and ensure the appropriate supply of financial flows for balance-of-payments and development financing.
- (e) A thorough revision of IMF conditionality is required to adapt it to the circumstances and needs of member countries in the current conditions of the world economy. The Fund's financial programmes should rely less on demand management and give

greater emphasis to the correction of structural imbalances. The Fund should try to equate the duration and the nature of the programme with the requirements of each country, and should consider carefully the various adjustment possibilities available.

- (f) The emergence of problems in the international capital markets and the increased role of the Fund make it imperative that it count with adequate financial resources. This requires a sharp increase in quotas and the provision of adequate credits by member countries when Fund resources are insufficient.
- (g) The present decision-making process in the Fund and in other international financial institutions must be reviewed, so as to attain a more equitable participation of developing countries in the decision-making process.
- (h) Substantial annual allocations of SDRs must be reintroduced, in line with the requirements of the world economy and the special needs of the developing countries. This action would strengthen the role of the SDR as an international reserve asset. The distribution of international liquidity must take into account the reserve needs of developing countries. Given the limited flow of official development assistance and the budgetary difficulties for its increase, it is essential to establish a link between the creation of international liquidity and the transfer of real resources to developing countries.
- (i) The areas of trade, development finance and money are closely related. Therefore, the reform of the international monetary system must be considered as part of a global programme of action that gives adequate consideration to the interdependence of these areas.

70. Although it is apparent that the present international monetary system has serious technical deficiencies, the main obstacles to its reform are not of a technical nature but lie in the absence of political will on the part of some countries of the industrial world. Many of the proposals made in this paper will only be viable in a climate of greater international co-operation.

FOOTNOTES

1. According to IMF estimates, of the \$ 66 billion increase in the aggregate current account deficit of the non-oil developing countries from 1978 to 1981, more than 90 per cent may be explained by the combined effect of the rise in net interest payments, the deterioration of the group's non-oil terms of trade and the adverse change in the group's oil trade balance. See IMF, World Economic Outlook: Occasional Paper 21 (Washington, D.C., 1983).
2. Argentina, Brazil, Mexico, Nigeria, India, etc.
3. For example, the downward movement of the Japanese yen and the Deutsche mark in 1981 and 1982 carried the dollar value of both currencies back to roughly the level of nine years earlier, despite the substantial inflation differential in favour of those countries in the period.
4. See IMF, World Economic Outlook, op.cit.
5. Access to this facility would be limited to countries which faced a liquidity crisis as a result of capital outflows or of a very sharp decline in access to external credit.
6. This was first proposed by Mexico in 1978.
7. The concept of structural adjustment has already been accepted by the Fund and has given rise to the Extended Fund Facility. In practice, however, most of the adjustment programmes undertaken under this Facility remain essentially a chain of conventional demand management programmes to which ad hoc measures of trade liberalization and production incentives have been added to stimulate a supply response.
8. Fund resources may be obtained through a combination of increased quotas, SDR allocations and Fund borrowing arrangements. It is well known that among these alternatives, the first two are preferable to the third. In this context, Fund borrowing should be considered as a bridging arrangement to cover a resource gap prior to the adjustment of quotas. Likewise, borrowing by the Fund should be resorted to if members' access to Fund resources is large relative to their quotas.
9. It is also assumed that quota and SDR sources maintain their distribution of end-1981 and that 25 per cent of the quota increases are paid in SDRs.
10. It must be stressed that, despite their magnitude, these figures must be seen as conservative since they do not take into account the larger role that the Fund will be called upon to play as a financial intermediary, nor the greater demands on its resources that may be expected as a result of the increased frequency and magnitude of structural imbalances in the difficult conditions of the current decade.



11. In recent weeks, the Managing Director of IMF has requested from industrial countries additional funds amounting to SDR 3-5 billion. So far, however, the negotiations do not appear to have been successful.
12. The situation is worse for the smallest countries since the relative size of the basic vote falls with each increase in quotas. Furthermore, these countries are in many cases represented by industrial country Directors in the Executive Board.
13. Instead, attention shifted to the question of how the role of the SDR could be enhanced, without contributing to the growth of international liquidity on a global basis, by means of substitution.
14. According to estimations of the Group of Twenty-Four, a minimal annual allocation of SDR 12 billion is needed so that the share of this asset in international liquidity returns to the 1972 level.

## LOW-INCOME COUNTRIES AND THE INTERNATIONAL MONETARY AND FINANCIAL SYSTEM \*

G.O. Nwankwo\*\*

### Introduction

1. The stake of the low-income countries in the international monetary and financial system - by which we mean primarily the rules, institutions, policies and practices regarding the adjustment and/or financing of external imbalances, the creation and distribution of international liquidity and the determination of exchange rates - stems largely from the vulnerability of developing countries to exogenous shocks and the difficulties these shocks pose for economic management generally, and the management of the payments position in particular. Within the broad group of developing countries there are analytical sub-groups of low-income structurally disadvantaged countries whose vulnerability is even greater and whose existing lines of recourse to the international monetary and financial system for support are even less adequate. This short paper focuses on the present position and immediate special requirements of these economies, within the broader context of global interactions between developing countries and the international monetary and financial system.

### Low-income and structurally disadvantaged countries

2. Developing countries diverge substantially with respect to their vulnerability to external shocks, their capacity for domestic management of exogenously generated instability and their effective access to the international monetary and financial systems for short-term and long-term resources to meet crisis needs, including structural adjustment and enhancement of production to regain balance. Those countries which have particularly low income in per capita and absolute terms suffer from a series of interlocking structural handicaps and are vulnerable to changes in the international environment to a greater degree than other developing countries. Characteristics leading to high levels of vulnerability, limited capacity for domestic response and inadequate access to the flow of international resources may be analytically grouped into two broad categories: (i) internal structural constraints, and (ii) the modus operandi of the international monetary and financial system.

\* This report draws heavily on a previous paper by the author on the same subject (UNCTAD/MFD/TA/25).

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### Internal constraints

3. Low-income countries form an analytical sub-group of the developing countries, comprising some 43 countries where per capita GDP, as estimated by the World Bank, did not exceed the equivalent of \$ 350 in 1978. These countries are to be found mainly in Africa and Asia. A great number of them are land-locked and/or in semi-arid zones, or consist of small islands, and are invariably prone to such catastrophes as earthquakes, floods, droughts and other similar acts of nature. Low overall national income is usually associated with a larger share of imports and exports in monetized GNP. It is also associated with a narrow range of exports vulnerable to international price fluctuations, paralleled by heavy import dependence for essential products, often including fuel, food and capital goods. Therefore, low-income countries are more susceptible to changes in international demand and less able to respond by altering export and overall production patterns than are larger economies. Internal structural factors thus impose severe constraints on the capabilities of the low-income structurally disadvantaged countries.

### External constraints

#### (a) Limited access to international capital markets

4. In general, countries with low per capita and low total GNP tend to have limited access to international bank credit, especially in circumstances of external imbalance, crisis and global uncertainty when they are most urgently in need of such resources. In practice, the access of the least developed countries to such credit has been negligible and at present a far broader range of low- and middle-income developing countries has no substantial access to commercial bank credits.

#### (b) Relative systemic unimportance

5. The international community tends to attach importance to system maintenance and is therefore inclined to attach importance to the extent to which the stability of the system can be threatened. Since low-income countries do not have sufficient bargaining leverage to threaten the existing system, the perception of mutuality of interests and concern in survival is much weaker. Thus the least developed countries are treated with benign neglect by the international monetary and financial system.

6. There are other important related points in connection with the above characteristics which indicate the extent to which the economic fortunes of the low-income countries are inextricably linked to the vagaries of external environmental factors. External markets provide the low-income countries with remunerative outlets for the export of their primary products in excess of domestic absorption. The

deterioration in external market conditions (e.g. recession, technological changes, restrictive fiscal and monetary policies and the increasing tendency towards protectionism) will tend to influence the volume, price and terms of trade of products from the low-income countries. Equally, changes in the modus operandi of the international monetary and financial system in relation to variability of interest rates, instability of foreign exchange rates and the operational policies of the financial institutions regarding the flow of resources will affect the economies of the low-income countries.

7. The low-income countries' need of external finance has increased considerably since the mid-1970s when a variety of factors in the industrial countries (e.g. sharp escalation of prices of essential foodstuffs and petroleum, rising prices of capital goods and the export-dampening recession, in part reinforced by the rigid monetarist policy) severely worsened the financial position of the low-income countries. The scale and severity of these developments were reflected in the poor economic growth of these countries, the deterioration in their balance of payments on current account, the worsening of their terms of trade and the weakening of their debt service capacity.

8. A country's ability to cope with a deterioration in its current account is related to its position on the long-term capital account as well. Given the exogenous origin of the problem, successful adjustment will depend on three sets of crucial factors:

- (i) the policies adopted by the industrialized countries;
- (ii) the response of the international monetary and financial system; and
- (iii) the internal adjustment policies.

#### Policies of the industrial countries

9. Since the mid-1970s, two interrelated factors have adversely affected the economies of the low-income countries: (i) the slowdown of economic activity in the industrial countries and - in response to this - (ii) the move to a high level of interest rates.

#### The response of the international monetary and financial system

10. Given its internal constraints, it is a country's access to external resources that will determine the success of its adjustment efforts. This in turn will depend on the ability (and willingness) of the international monetary and financial system to evolve suitable and sustainable policies regarding the flows of resources to the developing countries on affordable terms. The existing international mechanisms seem to discriminate harshly against the low-income countries. The present system distributes financial resources to the relatively richer



developing countries on the basis of some perception of creditworthiness while the least developed countries are obliged to adopt stringent adjustment measures which, invariably, drastically reduce their absorption of real resources from external sources.

### Internal adjustment efforts

11. Low-income countries, in large part, can and do take measures to protect themselves from payments deficits even though exogenous in origin, for example by accumulating foreign reserves when the payments position is relatively buoyant and drawing upon them to finance the deficits when necessary. But such a policy should be regarded only as an unavoidable short-term expediency. Reserve accumulation for the purpose of financing deficits entails high opportunity costs, including the impairment of access to bank credits and import capacity. External deficit is best viewed as the result of the shift in the terms of trade of the low-income countries and of the sluggish growth in their traditional export markets - a shift in the supply curve rather than demand curve - and not the result of imprudent over-expansion of spending or over-valuation of the exchange rates for which, according to conventional wisdom, the appropriate policy prescriptions are demand contraction and devaluation of the exchange rates. For example, in a number of sub-Saharan African economies and other low-income structurally disadvantaged economies, real import volume, real produce prices, real wages and salaries and real government expenditure have all fallen in recent years partly because of terms of trade deterioration of up to 50 per cent. This pattern - even if accompanied by inflation - cannot be justifiably regarded as external imbalance caused by excessive domestic demand. Adjustment in the external balance is more difficult and complicated when the imbalance emanates from the supply side, in particular between the foreign trade sector and non-tradeable sectors, and within the foreign trade sector, rather than in overall relation of expenditure to output.

12. To the extent that capacities are not readily switchable from production for home market, correcting an external deficit requires changes in the pattern of production involving expansion of productive capacities, i.e. new investment in export and import substitution goods. Compressing demand for non-tradeable goods to increase the supply of tradeables depends crucially on the consumption pattern and the extent to which production inputs are substitutable in the two sectors. However, given the internal structural rigidities and consumption patterns in the low-income countries, such transformation cannot be readily accomplished in the short-run to allow external deficit to be corrected by this strategy. Therefore, an attempt to correct a supply imbalance by reducing aggregate demand or by switching consumption away from imports and exportables is likely to contract output without necessarily inducing a commensurable increase in the output of the foreign trade sector, thus generating unnecessary loss of real income. The correct line of attack would be to expand the productive capacity in the foreign trade sector, while compressing demand for non-tradeables by no more than is critical from the standpoint of increasing exports. The appropriate blend of adjustment and financing is likely initially to

involve slower adjustment and greater financing when the imbalance is the result of the deterioration in the terms of trade, than when it results from an over-expansion of demand. Thus, successful adjustment to a deterioration in the terms of trade will require not only the avoidance of unduly restrictive (expansionary) policies regarding demand, but also a rise in the level of new investment.

13. When the capacity to save and the availability of foreign exchange have been impaired by a worsening of the terms of trade, it will be particularly difficult to increase investment solely through domestic efforts. What is needed is an increase in the flow of external financing, in conjunction with an increase in domestic savings, to enable the necessary expansion of productive capacity to take place, and do so without disrupting the economy as a whole. Payments financing thus needs to be underpinned by external assistance on appropriate terms and conditions.

14. Thus, successful adjustment to structural shift requires an expansion of productive capacity rather than a contraction of demand; otherwise the underlying disequilibrium will be suppressed rather than corrected, resulting in damage to the development process without removing the prospect of renewed payments pressures in the future. Adjustment through growth implies a need for time to make the adjustment - and hence for bridging finance - as well as additional capacities - and hence for long-term external resources. Both requirements need to be assured for a number of years ahead to allow for forward planning.

15. Given that the process of payments adjustments to a deterioration in the external environment involves issues affecting the pace and pattern of development, the orthodox distinction between payment support and development assistance overlooks the structural factors behind the balance-of-payments disequilibrium in the developing countries and, in particular, in the low-income countries.

#### The international response

16. To some extent, the increased payments pressures on low-income countries have been eased by some concerted efforts on the part of the international community. However, given the nature and the scale of the resource problems facing the poor countries, the response of the international monetary and financial system has been inadequate. This disappointing response may be attributed to a number of factors connected with the objectives, structure, modus operandi and the operational policies of the resource-channelling institutions.

17. Even since the establishment of these institutions, their structures have seemed immutable in the face of the evolutionary transformation that has characterized international relations since World War II. The economic ideology underpinning the policies of these institutions is firmly rooted in the conventional wisdom. Even though

it is generally accepted that the economic development process is dynamic in nature, the analytic approaches of these institutions are largely based on comparative statics. Thus the IMF's policies and instruments for dealing with the payments adjustment process derive their rationale from the monetarist conception of the origin of the external deficit which is assumed to be essentially caused by monetary maladjustment and thus requiring monetary prescriptions.

#### Response of the International Monetary Fund (IMF)

18. To a certain extent the Fund and (increasingly, even though tardily) the World Bank are accepting that the conventional dichotomy between temporary balance-of-payments finance and development finance is no longer tenable. The balance-of-payments disequilibrium and their associated adjustment policy and mechanisms are interlocked with the problem of the growth process and structural changes in the developing countries and, therefore, require common and integrated approaches.

19. Thus the Fund has established some facilities aimed at focusing on payments problems that are exogenously determined. The Extended Fund Facility (EFF) is a medium-term facility of up to 3 years to enable a country to cope with structural payments maladjustment. However, the Fund continues to insist on performance criteria whose rationale stems from a monetarist diagnosis of the external deficit rather than one based on structural characteristics. Similarly, standby arrangements have continued to involve the setting of precise theme-bound targets for money supply and bank credits. The Fund has made some notable improvements in the Compensatory Financing Facility (CFF). It has raised its quota limits from 75 per cent to 100 per cent and has decided to provide assistance in respect of temporary surges in cereal imports caused by poor harvest or higher import prices to be incorporated into the CFF. The Fund has, most significantly, raised the limits for drawing under quota to 150 per cent, with a maximum 450 per cent over a three-year period and a maximum of cumulative access to Fund resources, net of repurchases or repayments, of 600 per cent of quotas.

20. However, notwithstanding these modifications in Fund policy, the impact has not been adequate to deal with the acute problems of the low-income countries. The enlargement of quotas under the Eighth General Review of Quotas from \$ 60 billion to \$ 90 billion recently agreed upon has not yet been implemented and, in any case, the doubling of the existing quotas is significantly below what has been suggested as at best modest. Greater advantage would have accrued from a substantial increase in quotas than from the 600 per cent increase in the multiple of quota which had the effects of lowering a proportion of borrowing within limits attracting first credit tranche conditions. The increase in the proportion of quotas drawable under CFF must be set against the modest increase in quotas. Drawings to cover cereal-related deficits are only marginally additional to other CFF drawings and import price increases other than cereal are not taken into account. The ratio of deficit developing countries' Fund quotas to exports stood at 16 per cent over 1966-1968 and declined to 6 per cent over 1978-1981, while



that to current account deficits declined from 64 per cent to 12 per cent over the same period. Thus the increase in CFF limits in proportion to quotas (from 50 per cent in 1966 to 125 per cent in 1981) has not even maintained real values in respect of exports, while in respect to current account it has been halved. Further, the Fund alteration of the calculation of export shortfalls from an arithmetic to a geometric average based on the year for which CFF drawings are sought has - on the Fund's own admission - the effect of reducing the amount of shortfalls. Apart from this there has been no addition to low-conditionality resources comparable to the oil facility in 1974 and the Fund policy has in fact moved towards higher conditional borrowing for drawing under quotas. In particular, CFF drawings have sometimes been handled together with higher credit tranche and CFF drawings and thus subjecting them to high conditionality.

21. The foregoing shortcomings of the Fund's response are felt most by the low-income, structurally disadvantaged countries since for them the Fund is the lender of first as well as last resort. The stringency of Fund conditionality in the past has led many countries to avoid recourse to it, especially since their borrowing limits were not large. However, payments pressures have now reached the point at which recourse to the Fund cannot be easily avoided: credit tranche and EFF drawing rose from \$ 0.12 billion in 1980 to \$ 5.78 in 1981. Drastic curtailments in development programmes increasingly have been rendered unavoidable, partly because of the very high incidence of breakdowns and suspensions in agreements entered into since 1979 as the Fund shifted towards stricter conditionality.

22. For the low-income countries, the paucity of action with regard to Fund lending is a matter of serious concern. The Subsidy Account has received relatively modest contributions from members, and the Trust Fund monies - which constitute the principal resources for the Subsidy Account - involves no additionality: nevertheless, the users are subject to higher conditionality. Moreover, no subsidy account has been established for the Enlarged Access Facility as was fully applicable to its successor the Supplementary Financing Facility.

23. Low-income developing countries have received little relief from SDR allocations. This may be gauged by the fact that total allocations were some \$ 4 billion per annum for the third basic period (1 January 1978 - 31 December 1981), of which energy-importing developing countries received less than \$ 750 million.

#### Response of multilateral development institutions

24. The response of the multilateral institutions has been positive, but on the whole this has been modest in proportion. Long-term assistance flows have risen, but by much less than the financing requirements of the developing countries. Some bilateral donors have raised their resource transfers significantly; however, some major developed countries have opted to reduce their aid appropriations.



Assistance from OPEC member countries has continued to increase, and the proportion of GNP accounted for by aid continues to be much higher for OPEC donor countries than for developed market economies. However, since 1978 this growth has not been sustained - a manifestation of the general worsening payments position of all but a handful of oil-exporting developing countries as of 1982.

#### The World Bank

25. The major problems confronting the World Bank is the limited resources available. To a certain extent the growing shortage of resources as well as the policy guidelines of the Bank - as with the Fund - have constrained the access of the least developed countries. The World Bank's strong preference for "project" as opposed to "programme" assistance tends to limit the scope for its mediation role in the problems faced by the least developed countries. The Bank's capital base has been increased by a moderate degree. In 1980 the Bank inaugurated a structural adjustment lending programme designed to help countries overcome their current account deficit. The loans provide immediate quick disbursing payments support and permit countries to expand their exports by providing the foreign exchange needed. The loans, however, have built-in conditionality, since "the soundness and efficiency of the entire economy" will be the critical factor in judging how fully to support a country's development. In February 1983 the Bank launched its Special Action Programme aimed at protecting long-term development against short-term cash shortage. The programme is meant to get money faster to high priority areas such as crucial infrastructure and export projects.

#### International Development Association (IDA)

26. IDA, the largest single source of concessional finance for the low-income countries, is beset by fund crisis, forcing it to make cutbacks owing to a reduction in contributions below the levels agreed for the Sixth Replenishment. IDA commitments in fiscal year 1982 were \$ 2.7 billion from the planned \$ 4.2 billion and, significantly, below the level of the last few years (\$ 2.3 billion in 1978, \$ 3 billion in 1979, \$ 3.8 billion in 1980, and \$ 3.5 billion in 1981) especially in real terms. According to Mr. A.W. Clausen, IDA needs at least \$ 18 billion <sup>1/</sup> to maintain real lending levels but the prospect of reaching this target is doubtful. IDA loans, because of their low cost, are particularly critical to low-income countries, especially at a time when interest rates, even on semi-concessional loans (e.g. export credit, World Bank)

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<sup>1/</sup> IMF/Bank Annual Meeting 6-9 September, 1982. Reported in Third World Quarterly, January 1983, pp.160-163; also IDA in Retrospect, 1982, p.79.

are at or above 10 per cent. Consequently, these reductions have a disproportionately severe impact on the ability of these countries to procure foreign reserves at a bearable cost.

#### Official Development Assistance (ODA)

27. Between 1970 and 1979, total net financial resource flows to all developing countries from all sources increased from \$ 19 billion to \$ 81 billion. During the same period the composition of the total aid flow changed drastically: the share of ODA, 40-50 per cent at the beginning of the decade, slumped to 30-35 per cent in the late 1970s. Although multilateral lending rose from \$ 1.07 billion in 1970 to \$ 6.1 billion in 1979, the bulk of the increased inflow was concentrated in non-concessional resources which increased by \$ 42 billion from 1970 to \$ 53 billion in 1979. In terms of GNP, only Sweden, Norway and the Netherlands have complied with the goal of 0.7 per cent. For DAC members as a group the ODA/GNP ratio has decreased from 0.42 per cent in 1965-1967 to 0.34 per cent in 1970; it rose to 0.38 per cent in 1980, only to fall back to 0.35 per cent in 1981. The share of DAC members' bilateral resource transfers to the least developed countries declined from 41 per cent of the total in 1975 to 33.4 per cent in 1981. The diminution of the concessional assistance had led to a marked deterioration in the external payments of the developing countries in general and, in particular, of the poorer sub-group. A re-allocation of concessional assistance to the poorer countries is, in this context, as essential as increasing its overall amount.

#### Private financial market

28. The decline in the relative share of ODA in total resource flows and the inadequacy of complementary resources from the major multilateral financial institutions have compelled the non-oil developing countries to turn to the private capital markets. The bulk of redistribution of resources in the Euromarkets through the recycling process went mainly to the upper and middle-income non-oil developing countries which at that time were regarded as possessing growth potential and attractive creditworthiness. The low-income countries, on the other hand, lacking the credentials of creditworthiness, did not benefit to the same extent. This group of countries have no option but to fall back on the IMF conditional resources, which often oblige them to adopt adjustment policies which have tended to reduce their already poor and deplorable living standards.

29. The need for commercial borrowing by the low-income countries to stem the tide of economic recession or down-swings in export earnings and for development purposes is likely to continue. However, commercial lending - which is increasingly assuming a short-term orientation - should not obviate the need for increased flows of concessional finance to the least developed countries. What these countries need is adequate funds at concessional interest rates and extended maturities to help them bridge the gap until export receipts are sufficiently high to finance imports and development programmes.

30. Low-income countries have not been a major focus of foreign direct private investment. Only about 9 per cent of this flow finds its way to these countries. To the extent that they have been side-tracked by this type of investment, the low-income countries are not able to share in concomitant benefits such as access to technology and technical know-how and other potential benefits often associated with foreign direct investment.

### Recommendations

31. The measures proposed here are ones which could be adopted under the present system without waiting for long-term structural reforms. They do not constitute an alternative to such reforms but, rather, interim action needed urgently to avert a series of national economic collapses and global instability, pending world economic recovery and the negotiation of longer-term structural reforms.

### Immediate measures relating to IMF

- (a) The Compensatory Financing Facility (CFF) should be untied from quota limitations and related to shortfall of export earnings calculated in terms of import purchasing power, i.e., it should compensate for loss of earned import capacity. Repayment schedules should be linked with recovery of exports in terms of real import capacity, not tied to fixed time periods without reference to the degree of recovery from the shocks giving rise to the need for drawings.
- (b) The CFF should remain a low-conditional facility. Special arrangements should be made for the benefit of the least developed countries to subsidize interest payments and to lengthen repayment periods.
- (c) The Extended Fund Facility (EFF) should be made more "need related" in terms of eligibility, preferably by untying it from country quotas, but alternatively by more frequent use of waiver powers in respect of quota limits. The conditions accompanying drawings should place greater weight on achieving higher real output and maintenance, both of real household incomes and of basic public service provision levels, and less on particular domestic policy measures chosen for use in regaining international balance. Because "trigger clause" targets are calculated on specific assumptions about world economic variables (e.g. interest rates, export and import prices) and about domestic events not totally within state control (e.g. crop output, inflation rates), the targets should be subject to automatic adjustment on agreed formula bases if the actual levels of these variables diverge widely from those assumed at the time of programme agreement.
- (d) A "special window" should be set up as an emergency facility with, say, \$ 2 billion a year for five years to provide additional resources to the low-income countries facing severe adjustment



problems. Drawings under this facility should be concessional, not quota-linked, and should be eligible for inter-rate subsidy from Subsidy Account resources. Repayment schedule should be linked to significant external balance recovery, not to fixed time periods.

- (e) The Subsidy Account should be topped up to cover additional subsidy requirements under additional drawings resulting from proposals 1 and 3. Eligibility for such subsidies should be extended to include all least developed countries.
- (f) A substantial new issue of SDRs should be made over 1983-1985, in no circumstances less than 15 billion annually. Allocations should be delinked from quotas and related to structural trade account deficits and (lack of) access to commercial sources of finance. SDRs should be linked to development finance and there should, in the interim, be differential criteria for allocations, that is, weighted in relation to a country's need for resources.
- (g) A special additional allocation of SDRs should be made to allow the least developed countries to meet the requirements for increasing quotas under the Eighth General Review of Quotas.
- (h) In formulating conditionality the IMF should define conditionality in a way more favourable to the needs of low-income countries. Differentiated treatment which recognizes the differential burden of conditionality, rather than an even-handed approach, should be adopted as a more equitable way of dealing with low-income countries' problems. In its operating philosophy, IMF should take cognizance of the unequal relationships between the industrial countries and developing countries and in particular low-income countries. In this context, it should put the stress on supply expansion through new investments rather than on demand contraction, and should adopt a more flexible approach regarding particular adjustment measures chosen by drawing States. In this respect, it should recognize that forcing adjustment in the external account before adjustments in the productive capacity have taken place entails severe costs in terms of output and employment. The IMF should therefore support programmes that involve import reductions and export expansion through the growth of supply.
- (i) The IMF should be made more democratic in a manner which will enable it to recognize the exogeneity of the problems regarding external payment of low-income countries. This would lead to a better balance of financing and adjustment. The low-income countries should be given greater involvement in the decision-making process.
- (j) A new trust fund should be established, financed by profits from additional sales of the IMF's gold holdings and from interest due from the developed countries' allocation of SDR holdings, in order to make more concessional loans to the least developed countries.

#### Immediate measures relating to the World Bank group

- (a) In lending for physical and human infrastructure, the World Bank should pay more attention to the structural adjustment needs of the low-income countries. The share of structural adjustment and



analogous programme lending should be increased and the criteria for structural adjustment programmes should be made more precise. Structural adjustment should lead to a positive growth rate of real GDP while improving the structural balance between exports and imports. It should widen key structural bottlenecks while attaining high levels of capacity utilization. It should maintain and expand basic services without entailing worsened income distribution and without increasing the numbers suffering from absolute poverty.

- (b) The Bank should accelerate its five-year regular lending programme for the period 1982-1986 of \$ 60 billion so that it is disbursed over four years.
- (c) Substantially increase the proportion of local costs financed.
- (d) Raise the permissible margin of preference to 20 per cent.
- (e) Raise the share of programme loans to at least 20 per cent of total lending.
- (f) Because IDA is regarded as the largest concessional and impartial multilateral source of funds for structural adjustment available to structurally disadvantaged developing countries, it is crucial that attempts to provide new modalities for achieving its 1981/82 - 1983/84 target lending levels should be successful. It is also critical that the 1984/85 - 1986/87 replenishment be negotiated promptly, and at levels allowing a substantial real increase in IDA credit extension over the levels of 1981/82 - 1983/84.

#### Immediate measures relating to regional development banks

32. Regional development banks should increase the share of both soft window and programme lending in their total disbursements and the real levels of such lending.

#### Immediate measures relating to bilateral sources of finance

33. The terms of industrial economy guaranteed export credits to structurally disadvantaged developing countries should not be hardened in respect of interest rates and the maximum grace and repayment periods should both be lengthened - say to 3 and 12 years. Industrialized countries should take a more responsible attitude in not promoting such credits where they are an unsuitable source of finance (either because of the nature of the project or because of the medium-term external balance prospects of the economy) and by acting to ease terms on outstanding credits of this type which are creating, or may create, debt-service crises for developing countries, in particular the structurally disadvantaged developing countries. Governments should give urgent consideration to providing external borrowing guarantees to the present structurally disadvantaged developing countries for commercial borrowings, with special reference to those countries which have in the past had access to, and ability to service, such borrowings but have temporarily been pushed into the structurally disadvantaged category by post-1979 external shocks.

## SHORTCOMINGS AND INEQUITIES OF THE PRESENT INTERNATIONAL MONETARY AND FINANCIAL SYSTEM

M. Narasimham\*

### Introduction

Recent developments in the international monetary system have provided further evidence that the present international monetary arrangements are grossly inadequate to meet the problems of developing countries and, indeed, to meet the objectives of international monetary stability for which purpose these arrangements were put in place. Major changes have taken place in terms of the size and structure of the world economy and at a pace which has outstripped the ability of the international monetary institutions to cope with the emerging needs of the international economy.

### The historical background

The International Monetary Fund was set up at the end of World War II against the background of the painful international currency experience of the inter-War years. The founding fathers of the Fund were, so to speak, so obsessed with the distortions caused by fluctuating exchange rates, competitive depreciation and restrictions on free movement of money across frontiers that they fashioned the International Monetary Fund in terms of a set of objectives which placed emphasis on stability of exchange rates and relative freedom from restrictions on currency movements. In pursuance of the first objective they opted for a system of fixed and unitary rates enshrined in the par value system and for, what in effect was, a gold exchange standard as reflected in the setting of par values in relation to a fixed dollar price for gold. Reflecting the concern for exchange stability, changes in exchange rates were to be permitted only in cases of "fundamental disequilibrium", a phrase and concept which permitted a great deal of discretionary and judgmental evaluation.

Equally reflecting their concern to avoid restrictions on exchange movements, the Fund's Articles had, as an objective, full convertibility of exchange, those countries which opted for restricting full convertibility of their currencies being put under the so-called transitional provisions of Article XIV. It bears mention that the IMF was conceived as part of a tripod of international arrangements, one of the other two legs being represented by the International Bank for Reconstruction and Development (IBRD) and the other by the International

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Trade Organisation (ITO) which, however, proved stillborn. The GATT cannot be regarded as an adequate substitute for the originally conceived ITO and the fact that the ITO did not come into being, if anything, placed an extra burden on the Fund's ability and effectiveness in helping to create an open multilateral trading and payments system.

The Fund's Articles also provided for the provision of financial accommodation to its members to overcome temporary balance-of-payments difficulties. This stemmed from the idea of preventing countries taking recourse to deflationary domestic policies in an attempt to restore balance in external payments. Quotas represented the contribution members made to the resources of the Fund and also determined the extent of access to its resources by members in need of accommodation.

Again reflecting the inter-War experience, the Fund's role was conceived as an agency to promote monetary co-operation and as an international monetary policeman that would put it in a position to enforce its discipline on both deficit and surplus countries and to avoid the excesses of nationalist beggar-my-neighbour economic policies. The "Scarce Currency Clause" was not put into the Articles by accident; that it never was invoked, despite occasions that might have indicated the need for it, is another matter.

Over the years, the evolution of the Fund has shown the increasing distance between its objectives and the evolving realities of the international payments system. As long as international liquidity was being provided for by the stock and production of gold and the deficits which the United States was running, the problems did not surface to a point calling into question the inherent contradictions of the system. By the late 1960s the industrial nations of Europe and Japan had rebuilt their economies and were beginning to question the prerogative of one country, however dominant, financing its deficits by issue of its currency and in the process providing international liquidity. Doubts were raised about the fragility of such dependence. There was also, rightly, growing dissatisfaction with the system of reserve assets which the emergence of multi-currency reserve assets did not help to alleviate. The skewness in the holding pattern of monetary gold and the uncertain and oligopolistic character of its supply made gold an unreliable and iniquitous source of liquidity. There was clearly the need to consider an alternative and internationally accepted means of increasing liquidity through discretion and concerted international action rather than through the happenstance of a single country's deficit or fluctuations in the price or supply of gold. It was also clear that the international economy needed an internationally accepted reserve asset. The culmination of the quest was the institution of the Special Drawing Rights (SDRs), a decision which one expected would mark a major watershed in the evolution of the international monetary system. Meanwhile, pressures were mounting on the system and the first major crack developed when the United States suspended the convertibility of dollar into gold in 1971. This event marked the effective collapse of the dollar exchange standard and the role of the US dollar as a stable international source of value. There followed a brief period of confusion in currency alignments which was only temporarily resolved by



the Smithsonian Agreement of December 1971 only to be followed by the subsequent dollar devaluation. The floating rate system was born out of this chaos and has come to stay. In the process, the par value system so central to the original scheme of the Fund, has ceased to exist with gold no longer providing a fixed point of reference. The Jamaica Agreement of 1974, subsequently codified in the Second Amendment of the Fund's Articles, officially demonetized gold; currencies were allowed to float against each other on the basis of the market's perceptions, subject to a degree of official intervention. Here too, views regarding intervention have been changing over time with a strongly prevalent but not universal view that less intervention is better. Consequently, we have considerable variations of rates sometimes not grounded on the inherent strengths of the economies concerned but reflecting more the short-term impact of various domestic monetary and other policies, not to speak of speculative pressures and destabilizing short-term capital movements. The result has been a misalignment of currencies on the one hand and extreme volatility in exchange rates on the other, both of which have not been helpful in bringing about any semblance of monetary order. The growth of the Euromarkets and the internationalization of private capital flows not subject to any discipline has added to the volatility of exchange rates and made the task of international monetary management extremely difficult. Nor has the Second Amendment, which placed so much weight on the institution of the SDR, been followed up by an adequate issue of SDRs leaving that creation a victim, if not of infant mortality, of retarded growth.

While these developments have affected all countries adversely, the developing countries have found to their cost that they are more vulnerable to the current international monetary turbulence. This vulnerability has been aggravated by the global recession that we have witnessed in the last few years. In an expanding world economy the problems for the developing countries did not surface in this acute form. International liquidity was expanding, albeit insufficiently and in a haphazard form. The international banking system was active in recycling the surpluses of the oil-exporting countries to those developing countries that sought recourse to the market and the modest increase in international resource transfers provided some relief to the low-income countries. However, with the emergence of worldwide recession and the reversion to economic nationalism the problems for the developing countries have become pressing. Aid flows have shrunk sharply in real terms; the international banking system has not been able to repeat its earlier success in recycling and developing countries have had to turn increasingly towards "official" international financing. Developed countries have their own cosy arrangements - currency swaps, BIS facilities and recourse to the General Arrangements to Borrow (GAB) should it become necessary. Developing countries have only the international financial institutions to turn to. These institutions have not had the resources or ability to provide adequate relief. IDA is in disarray. The IBRD's lending programme is proving inadequate. As for the Fund, as we will see presently, its ability to provide assistance has been constrained by an inadequate growth of its own resources and a hardening of its policies.

Though the Preamble to the Articles of the Fund speaks eloquently



of the need for the Fund to promote world trade, employment and real income and the "development of the productive resources of all members as primary objectives of economic policy", the Fund has consistently and perhaps with some justification - taken the view that it is not the agency for providing developmental finance, this being more appropriately the function of its twin - the World Bank. The Fund has also stressed the short-term revolving character of its resources in that its function primarily lies in providing balance-of-payments support to correct short-term disequilibria in payments, arising out of temporary or cyclical factors. One cannot quarrel with this particular stance. It represents a congenital defect stemming from the limited scope of the Articles in relation to the problems of developing countries. Nonetheless one would have wished that the Fund in approaching the problems of developing countries would have evolved in a manner that took into account their special vulnerability to developments in the international economy and the structural aspects of this problem and the related fact that, because of structural problems, the return to a sustainable deficit takes a longer time.

That the Articles paid little attention to the problems of the developing countries is not a matter of surprise. When the Fund was set up, there were, outside the Latin American countries, barely half-a-dozen developing countries amongst its membership. Today, over 120 countries out of the total Fund membership of 146 are developing countries and the Articles of the Fund which, as mentioned earlier, reflected the concern to avoid inter-War currency experience, have relevance more to the problem of developed industrial countries than the developing countries. Nor given the present voting structure of the Fund (and we will return to this point later) could one expect amendments to the Articles to reflect the needs and basic concerns of the changing composition of its membership.

#### Areas of inadequacy

It is against this background that one might discuss the specific areas where the Fund's organization, policies and procedures have revealed shortcomings in relation to the needs of the world economy and the specific concerns of the developing countries.

#### The size of the Fund - quotas

The first and indeed basic inadequacy relates to the size of the Fund. Over the years, there has been a disparate rate of growth in the size of the Fund in relation to world trade which, in a broad fashion, determines the need for international liquidity, for short-term balance-of-payments adjustment as distinct from the longer-term need for transfer of resources to developing countries. Aggregate quotas in the Fund represented about 16 per cent of world trade in 1945. By 1960 the ratio had declined to 11.5 per cent. By 1981 it had been further whittled down to under 4 per cent, despite seven reviews of the quota levels over the period.

The story with regard to the enhancement of quotas is an unhappy one. The Fund was conceived pre-eminently as an international co-operative agency with quotas representing not only the contribution of members to the institution but also the measure of the extent to which they could draw on its resources up to a point virtually unconditionally (the reserve tranche) and beyond that conditionality. Despite the strong and widely accepted case for raising the level of quotas sufficiently high to reflect the expansion of world trade and payments and the expected use of its resources this has not happened. The Eighth Quota Review that has just been agreed upon (but not yet ratified by all countries) is quite inadequate and reflects the pressures under which the system is straining. Despite a strong technical case made out by the Fund management and staff, and the overwhelming support of the membership of the Fund, for at least a doubling of quotas the opposition of the major industrial countries has effectively contained the quota increase to less than one and a half times the existing levels - and even this order to increase may not have come about if some of the major countries were not worried about the implications for the international banking and financial system of the serious debt crisis that emerged in the autumn of 1982. If the Fund is to play a meaningful role in the 1980s the first requirement is that it should be adequately funded - primarily with its own resources. The inadequacy of the Eighth Review, which is yet to become operational, calls for consideration sooner than later of a further enlargement of quotas. To be sure, the General Arrangements to Borrow has been expanded to take care of additional funding requirements but this cannot by any means be regarded as an effective substitute either quantitatively (despite their higher coefficient of usability compared to quotas) or more importantly, qualitatively for a Fund with adequate quotas. The rhetoric has always been eloquent about the primacy of quotas among the Fund's resources; the reality has been otherwise. To be effective the Fund needs a "critical mass" of its own resources. The Eighth Quota Review does not provide this minimum quantum.

While on the subject of quotas, a reference may be made to the suggestion of developing countries for a reconsideration of the variables included in the quotas formulas and the weights to be attached to them. The Eighth Review paid no attention to this and in fact in the result the share of developing countries as a group, and the non-oil developing countries in particular, has suffered a further erosion.

The inadequacy of the size of the Fund has inevitably meant concern with its liquidity position and, at one remove, has led to a severe rationing of its resources. Instead of evolving to be the ultimate source of international liquidity, the Fund has had to be content with dispensing what in effect is a given stock of such liquidity within its control. The tests applied for provision of such liquidity have been getting stricter as the demand has tended to outstrip supply. The increasing stringency of conditionality could be viewed as an aspect of this phenomenon.

### Conditionality - rationale and content

Conditionality, of course, is the unique and distinctive feature of the Fund's assistance. This characteristic is sought to be justified by the revolving nature of its funding and to the purpose of Fund accommodation in providing finance for adjustment. Finance and adjustment obviously have to go hand in hand. Finance without adjustment would be self-defeating, even as adjustment without financial underpinning would not be feasible. As a lending institution, it is entirely right that the Fund should satisfy itself that its resources are put to effective use.

Obviously, therefore, one cannot argue against the principle of conditionality but what one would like to see is the Fund applying its own precepts, as laid down in the Guidelines for Conditionality, of taking into account the social and economic conditions in member countries in formulating the conditionality in respect of its lending in individual cases, without detriment to the principle of uniform treatment of members. This is all the more so when the factors that have recently brought about the need for developing countries to approach the Fund have in an overwhelming number of cases been exogenous to them, reflecting their greater vulnerability to the serious distortions in the international economy. They have suffered from the continuation of inflation and global recession arising out of the policies of the industrial countries. The deterioration in the terms of trade of the developing countries, especially of the non-oil developing countries, the weakening of the market demand for their exports, and the rise of protectionism in the industrial countries have all combined to widen their current account deficits to unprecedentedly high levels. The sharp increase in real interest rates in the recent past has made this problem of financing these larger deficits both difficult and costly and has aggravated the debt-servicing problem for those countries that have customarily drawn on the resources of the international banking system. The hesitancy of the international banks to continue to expand their lending in the light of country exposure problems and bank regulatory provisions has further added to the financing difficulties. For the low-income countries which have little or no access to the private capital markets the decline in real - and in some cases even nominal - terms of official development assistance and soft multilateral credits has made their position well nigh desperate.

### Conditionality and structural adjustment

While the developing countries have not always been responsible for the predicament they are in, there is no escape for them but to adjust to the deterioration in their external account, especially if some of the factors that have brought about such a deterioration are unlikely to reverse themselves. Hence the need for them to effect structural adjustments, and one would legitimately have expected that the Fund's policies would evolve in the direction of providing financial support for such adjustment. Indeed, it was in recognition of this need that in the mid-1970s the Fund instituted the Extended Fund Facility (EFF),



which appropriately places increasing emphasis on measures to strengthen the supply side of the national economic equation. Yet actual experience has shown that in a large number of cases the traditional concerns of the Fund with demand management have manifested themselves in the specifics of the conditionality prescribed even in EFF programmes. The somewhat dismal record of the number of EFF cases which have foundered on the rock of conditionality in its demand management aspects is instructive in this regard. There is evidence that the Fund continues to rely somewhat excessively on a simplistic monetary model which emphasizes the need for restraint on monetary expansion and in particular on the fiscal impetus to such monetary expansion. There is perhaps an inherent contradiction here in that the need in structural adjustment programmes is for an expansion of investment in critical and often non-tradeable infrastructural areas funded by the public sector. This is not to argue against monetary ceilings as such but that often the ceilings seem to be set at levels which make compliance difficult. Furthermore, instead of the rigid application of ceilings as at present, where even a minor deviation (in the absence of waivers) invites a suspension of the drawing facilities, consideration could be given to a pro rating of the drawing in relation to the deviation. This would seem more appropriate than the present "all or nothing" approach. A suggestion that has been made before and which merits consideration is the prescription of a range of ceilings rather than a specific figure. These changes would add some flexibility to the system. Furthermore, the somewhat naive faith of the Fund in what may broadly be termed as the market mechanism does not take adequate account of the socio-economic and indeed political compulsions in many developing countries. The policy suggestions often are more appropriate to developed market-oriented economies and do not pay adequate attention to the fact that the membership of the Fund today covers a wide spectrum of countries with different social and economic systems. The demand management oriented content of conditionality constitutes a major shortcoming of the present operational policies of the Fund and clearly needs review, especially in respect of structural adjustment programmes.

#### The recent hardening of conditionality

An interesting aspect of the hardening of conditionality is that this has happened especially in the last 2-3 years reflecting, one suspects, the predominance in the Board of the Fund of those countries which now have decided to emphasize demand restraint and the role of monetary policy in domestic economic management and place faith in the "magic of the market place". In fact it is an interesting thought that while after the first oil price increase the Fund showed a high degree of sensitivity to the problems of the countries affected by the deterioration in terms of trade represented by the oil price hike, the period following the second oil price increase has not only not witnessed such an understanding response but indeed has coincided with a period of tighter conditionality. Thus, the period following the first oil price increase witnessed the enlargement of the Compensatory Financing Facility (CFF), the institution of the Extended Fund Facility (EFF), the creation of two oil facilities and the imaginative action with regard to gold sales and the establishment of the Trust Fund (TF). It was also the period when the Supplementary Financing Facility was put



in place. Contrast this with what has happened in the face of the much more serious impact of the second oil price increase and the massive deterioration that it represented for the non-oil developing countries, coinciding as it did with global inflation and recession in this period. Not only were there no new facilities comparable to the oil facilities of the earlier period but in fact many countries were repaying the old oil facilities even as they were finding it difficult to cope with the problem of financing the larger deficits. Indeed, the failure of the Fund to evolve in directions which would recognize the special circumstances of developing countries and their vulnerability to international monetary disorder has never been more evident than in the last few years. The structural/conjunctural problems have affected the developing countries, especially the non-oil and low-income countries, with particular severity. The latter are also those which are not able to go to the international capital markets for financing their current account deficits. The deterioration in the aid climate has aggravated their position. At this time when this would have called for a broadening of the scope of low conditionality and low cost financing by the Fund the evidence points the other way. The Trust Fund has ceased to operate though the case for such a facility is stronger now. Nor are there the low cost facilities such as the earlier oil facility. The interest subsidy scheme on Supplementary Financing Facility borrowing is, in its very nature, limited in scope. One can also discern a tendency to move away from medium-term structural adjustment type of lending and the emphasis is reverting to the traditional one-year type of standby arrangements with their pronounced emphasis on demand management aspects of policy. The EFF represented a response by the Fund to the challenge of structural adjustment arising out of a shift in the payments position of a more permanent as distinct from a short-term or cyclical nature. Unfortunately, the evidence is growing that those countries that effectively control the Fund's policies have little faith in the extended arrangements. On the CFF there has been some marginal improvements inasmuch as there is limited provision for cereal import financing, unfortunately within the framework of an integrated facility which reduces its effectiveness. The plea of developing countries that the CFF should be extended to cover not only export shortfalls but also a deterioration in terms of trade which now is quantifiable and measurable remains to be answered. The other shortcoming of the CFF is that the quantum of accommodation under it is limited by relating it to a proportion of quotas rather than the need arising out of shortfalls in export earnings. There is in fact a case for expanding and enlarging the coverage. On the other hand, one cannot but view with concern the attempt to introduce (and beyond a point tighten) conditionality in what has come to be accepted as a low conditional facility like the CFF through a stricter application of the so-called test of co-operation.

The relative absence of waivers and the number of interruptions of the Fund's programmes is a reflection of the severity of the conditionality that is being applied and an inadequate comprehension of the far-reaching and exogenous character of the payments crises facing many developing countries, and of the absence this time around of the earlier success with the recycling mechanism and the marked deterioration in the climate for external development assistance.

Case for an evaluation of Fund programmes

It is a moot question whether the programmes of the Fund have in fact been effective in relation to their stated objectives of balance-of-payments adjustment, even in the few cases where the countries concerned have fully met the performance criteria. Equally there is no dearth of evidence that some countries have succeeded in improving the external account, even if they have not always met the conditionality tests. This only serves to underscore the importance of other variables, often exogenously induced, and of approaching the question of performance tests with becoming modesty. The reviews by the Fund of the experience with its programmes give little benefit of the doubt to countries that have failed to meet the tests, despite their best efforts to live up to the stern discipline of conditionality, especially when such failure has been due to factors beyond their control. There is a strong case for an in-depth, systematic and introspective study analyzing Fund experience with programmes covering a period of say 5 years in differing country contexts. This could be done, if not by an outside group, at least by an autonomous group within the Fund, somewhat on the lines of the Operations Evaluation Department of the World Bank, reporting to the Managing Director and Executive Board directly. Such an exercise could help to draw appropriate lessons for Fund policy prescriptions, which often go to the very heart of the economic, social and political policy mix in member countries.

Need for a medium-term facility

Another aspect of the inadequacies of the lending policies of the Fund relates to the virtual absence of a truly medium-term facility. The EFF provides for repayment over a medium term but the finance itself is generally available up to a maximum of three years (except in cases where the programmes are so heavily back-loaded as to stretch it into another year without necessarily increasing the quantum of finance) whereas the requirements of finance for structural adjustment often go beyond three years. The fear that such an elongated period of provision of finance would make the Fund a development agency has little logical foundation. Apart from the fungibility of funds argument, the recognition that the Fund has a role to play in structural adjustment with its emphasis on investment and on the supply side is an appropriate response to the realities of the current situation. There is no reason why growth should be sacrificed on the altar of adjustment. On the contrary, if structural adjustment is to be successful it must be integrated into a growth-oriented investment programme. There is thus no need to be defensive about the provision of medium-term finance which would help to make the effort at structural adjustment viable and successful without detriment to the revolving character of Fund resources. "Revolving" is not necessarily synonymous with short-term. It only emphasizes the requirement on the part of the country to repay in full and on time.

The internal logic of conditionality seems to rest on the premise that the greater the dislocation in external account (even if it be due

to exogenous factors) the more stringent should be the adjustment effort. However, one could argue with equal, if not greater, validity that, precisely because of the more difficult external environment and without any sacrifice of the principles of sound economic management or the imperatives of structural adjustment, the affected countries ought to be given more time and more room for manoeuvre in readjusting their policies and production patterns to meet the new challenges. The point can legitimately be made that there is an optimal pace of adjustment. This is no longer for developing countries than for developed countries. It is also longer the greater the external shock and where a degree of structural adjustment is called for. The global recession has aggravated the difficulties and lengthened the process of adjustment. The Fund's policies should have shown greater flexibility in recognition of this problem. It is this degree of understanding that the developing countries seek, especially as pushing for a faster adjustment than the "optimal" rate only forces a deflationary adjustment. A deflationary adjustment can only aggravate the deleterious impact on them of the global recession. It is bad for them and indeed bad for the world economy.

#### The present asymmetry in the adjustment process

The stern discipline which the Fund enjoins on its borrowing members contrasts with its less than effective influence on the policies of the surplus and strong countries despite the observed fact that often it is the actions of the strong that have contributed to the unprecedented monetary turbulence which we have witnessed in the recent past. When concerns are being expressed by major industrial countries about implications for them and for the international economy of the policies and actions of other major countries, it is little wonder that developing countries are even more concerned, despite their being reduced to no more than helpless spectators of events and policies over which they have no influence but of which they are the victims. The Fund has been powerless - despite its well-meaning remonstrations on protectionism, the inadequacy of official development assistance, the excessive reliance on monetary policy (and interest rates) to correct inflation and the need for harmonization of policies in the major dramatis personae of the international monetary system - to influence the strong. The glaring asymmetry of the Fund's surveillance functions must be regarded as yet another major inadequacy of the present arrangements. The reference in the Versailles and Williamsburg communiqués to the role of the Fund and the reported confidential consultations of the Fund with the major countries notwithstanding, the Fund is yet to play an effective role in disciplining the strong countries. In this sense, the developing countries would like a strong Fund so that the right instincts to which the Fund Management has given expression on several occasions can be translated into an effective exercise of the surveillance function in respect of the major industrial countries so as to bring about a greater degree of synchronization of their policies, and appropriate policy responses by them to the problems of the developing countries. The burden of adjustment is not one which the deficit countries alone have to bear. It is equally incumbent on the surplus countries, given the essential symmetry of payments imbalances. Policy responses by the industrial countries in promoting



domestic economic activity, expanding market access and increasing the transfer of resources to the developing countries are at least as important as domestic policy measures to be taken by deficit developing countries in bringing about balance-of-payments adjustment. The floating rate regime has perhaps made the problem of asymmetry worse. In its own way the par value system enjoined a discipline of a kind. Under a system of floating rates, countries can depart from that discipline by allowing greater variation in exchange rates of their currencies and thus avoid taking the needed adjustment measures. The asymmetrical nature of prescribing adjustment measures is not only ineffective; it is iniquitous. The dominance of the major countries in the councils of the Fund, however, does not give ground for hope that they will permit the Fund to be effective in respect to them and fulfill one of its primary objective of combating economic nationalism and fostering international monetary co-operation. It is a sad commentary on the state of international economic affairs that, despite the existence of the Fund, we have witnessed recently the pursuit by major countries of policies of economic nationalism without regard to the implication for the rest of the world of these policies - a situation reminiscent of the inter-War period.

#### Exchange rate volatility

Another major weakness of the present arrangements is the continuing volatility in exchange rates, which understandably affects the developing countries more. The uncertainty surrounding import payments and export receipts makes the task of economic management more difficult for them. The link which their currencies often have with major currencies leads to exchange rate variations for them often unrelated to their particular circumstances. Nor are they able to take adequate offsetting action through operating on forward markets the way developed countries can. A decade's experience with floating rates has shown its inadequacies and that it is not the right solution to the problem. It cannot claim to have succeeded in improving the operation of the adjustment process, nor can it be said to have helped with the international liquidity problem. We are still to find the mean between the recognized rigidities of a par value system and the dislocating and destabilizing uncertainties of floating rates.

#### Unconditional liquidity - the inadequacy of SDR allocations

As regards the creation of unconditional liquidity, the record has been dismal. The inadequacy of quota increases has already been referred to. The institution of SDRs represented a major victory for those who believed that creation of international liquidity had to be on the basis of agreed international decisions and should allow for a measure of judgment and discretion. It represented a triumph of reason over circumstances. Yet despite the rhetoric surrounding the creation of SDRs - that it should be the principal reserve asset and the centre-piece of the international monetary system - the reality is otherwise. The share of SDRs in non-gold reserves has fallen sharply in the last few years. Though there was a global need for addition to international



liquidity through SDR creation, in the second "basic period", a meagre SDR 4 billion was allocated annually. Even this has now ceased. There has been no allocation since January 1982, on the specious ground that this would contribute to inflationary pressures in the world. It is known that the Fund staff had clearly demonstrated that the inflationary consequences of SDR allocation of up to about SDR 10 billion were virtually nil. In any event, if one were to assume that it would be the non-oil developing countries that were most likely to use the SDR allocations for settling their current payments and given their possible share in such allocation of about 21 per cent, it can clearly be seen that the actual addition to international purchasing power of SDRs 2 billion per annum would hardly make for any inflationary pressures. If anything, by increasing their import purchasing power, it would have helped both them and the international economy in a period of global recession and provided an impulse, however, small, to world economic recovery. Yet, we have witnessed a resolute objection by some major countries which have a commanding voice in the international monetary system to any allocation of SDRs, despite an overwhelming case for it on the ground of adding to the stock of non-gold reserves and as a proportion of such reserves to world trade, and despite the urgency of the need for the developing countries to have access to this source of unconditional (but not cheap) liquidity. The abatement of inflation in the major countries, the continuing crisis for the developing countries and the halting nature of world economic recovery suggest that the case for a large allocation of SDRs now is both necessary and desirable. To suggest that in a world of floating rates and borrowed reserves there is no need to create international liquidity is to ignore the situation of the developing countries, which cannot expect to be principals in the action on floating and many of whom have little or no access to borrowed reserves. There is some evidence more recently of a thawing in the attitude of some major countries to the question of a resumption of SDR allocations. At the same time one cannot but be concerned about suggestions that the SDR allocation should be made to the Fund rather than to individual countries. This would negate the unconditional character of SDR allocation so far, which has been its major attractive feature.

Along with a substantial SDR allocation, consideration needs to be given to altering the present system of allocating SDRs on the basis of quotas. This results in the countries that need SDR allocations most - generally the developing countries which also happen to have small quotas - getting the least. A change in the pattern of distribution could be regarded as a half-way house to the SDR-link idea, the prospects for which cannot be regarded as bright in the current state of thinking, despite the clear logical and intellectual case for such a proposal.

#### Recent attempts to circumscribe the Fund's role - enlarged access

The combined effect of failure to allocate SDRs and keeping quotas at modest levels is reflected in an increasing pressure on the Fund's resources. One suspects, in fact, that the reluctance of some countries to expand unconditional liquidity through SDRs is not unrelated to their

emphasis on the tightening of the Fund's conditional liquidity. It is the same countries that have also been questioning the access limits by members in relation to their quotas. These were set some time ago in terms of the Enlarged Access Facility at a maximum of 600 per cent of quotas with a sub-ceiling of 150 per cent in any single year. At the time of the quota revisal some countries have served notice that these access limits would need downward revision. Clearly there is no warrant for this. In the past, quota increases have not been accompanied by any such downward revision of access limits.

#### Should the Fund be a lender of last resort?

It is these same countries that are now propagating the doctrine that the Fund should be only a lender of last resort to individual countries, and presumably to the system. This again goes against the Fund's own advice to borrowing countries that it would make better sense to come rather early in the emergence of balance-of-payments difficulties, when successful adjustment could be more feasible and less painful than coming at a stage when measures would have to be more drastic and severe. This is yet another case where the evidence is that the policy postures of some important countries are coming in the way of Fund Management acting in a responsive fashion to emerging needs. The view that the Fund should be lender of the last resort is another way of saying that countries should approach the international capital and money markets before approaching the Fund. Apart from the fact that this prescription has little relevance for low-income countries which may not have the creditworthiness to go to the markets and, even if they did, could not afford market rates of interest to finance their deficits, even in respect of those countries that have used this source of finance, one would have thought that the current international debt crisis would draw attention to the dangers of an excessive reliance on the international capital and money markets for developing countries.

#### The impact of the debt crisis

The international debt crisis has cast a new responsibility on the Fund which, for the sake of protecting the financial stability and confidence in the international banking system, has been providing assistance to countries in the form of a "seal of approval" and acting to catalyze private funds. While the efforts of the Fund to play this catalytic role and to prevent a serious international banking crisis are commendable, there is equally the apprehension that, on the ground of maintaining the confidence of the international banking system in continuing to lend to debt crisis ridden countries, the conditionality it prescribes could be excessively stringent.

The debt crisis was a predictable sequel to the particular policy instruments chosen by the major countries in their efforts to control inflation. The primacy given to controlling inflation in the major countries is not in question but the instruments of policy, with their excessive reliance on monetary policy, have had wider adverse

repercussions. The paradox however remains of the co-existence on unemployed resources of manpower and equipment in the industrial countries with inadequate purchasing power in the developing countries - a paradox which derives as much from the structural and institutional inability of the international financing agencies as it does from the policies pursued by the major industrial countries.

The role of the international financial agencies could and indeed should have been contra-cyclical in helping to alleviate the impact of the recession and aiding the process of recovery. That it has not been so derives once again from the influence on its policies of the major countries, which has resulted in the prescribing of deflationary policies - which has only aggravated the problem for developing countries and, indeed, could be regarded as inconsistent with the spirit of the Articles.

#### The need for reform

Over the last few years, the response to the international monetary disarray and the emergence of the debt crisis has been to find temporary solutions. The type of ad hoc arrangements for crisis management that we have witnessed cannot be a substitute for a plan of international monetary reform. Such arrangements have only added to the complexity and fragility of the system, virtually making it a "non-system". The time for such piecemeal ad hoc and partial efforts at reform has passed. If we have to evolve a system where we are not moving from one monetary crisis to another, as we have been doing for nearly a decade, the role of the Fund would need to be redefined so as to make it more responsive to the emerging requirements of the international economy and more specifically to the legitimate needs of developing countries.

Such a redefinition of the role of the Fund as part of the effort to bring about a better and more stable international monetary order should be part of a thorough-going international monetary reform. The objectives of a comprehensive reform of the international monetary system would, in addition to what the Preamble to the Articles now spells out, have, illustratively, to take into account specifically

- (a) the creation and distribution of international liquidity to meet the expanding needs of world trade and the specific circumstances of developing countries;
- (b) the widening of the facilities for financing shortfalls in exchange earnings or increases in import payments arising out of factors beyond the control of member countries;
- (c) the creation of effective mechanisms for symmetrical surveillance and discipline of both deficit and surplus countries;
- (d) the creation of mechanisms for the effective supervision of the activities of the international banking system;



- (e) the establishment of a framework for dealing with international debt crises and for avoiding such crises in the future.

All this would clearly call for certain basic amendments to the Fund's Charter and style of functioning and this is where the inadequacies of the present system merge with its inequities. The system of weighted voting devised in the Fund gives a virtual veto in respect of important amendments to the Big Five, perpetuates the asymmetrical nature of its functioning and effectively precludes any major revisions which do not have their support. Indeed, for some basic amendments, a single country has virtually the veto power. Hegemonism by a single country, or a small group of powerful countries, is inconsistent with the international character of an institution like the Fund. One could appreciate the argument that in a financial institution weighted voting is unavoidable but the question that legitimately arises is whether this degree of skewness of the weighting pattern is justified, either on grounds of equity or indeed of efficiency. The developing countries as a group would have no more than 38 per cent of the proposed quota under the Eighth Review. The non-oil developing countries, which constitute the majority of the Fund's membership, would have an even smaller proportion at 26 per cent. It is no surprise, therefore, that the developing countries have not been able to get the Fund to evolve in directions that would have addressed their legitimate concerns. To bring about a degree of balance in the voting pattern and increasing the role of developing countries in the decision-making process in the Fund would require a conscious decision by some of the larger countries to forego some of their voting power to accommodate the developing countries but to expect this act of statesmanship would be much too naive. On the other hand with the existing power structure, the ability to bring about reform in the Fund's operations and policy would depend upon a greater degree of understanding on the part of the developed countries. Sympathy and compassion have perhaps no place in the lexicon of a financial institution but understanding the problems of the weak in an interdependent world is not outside the realm of statesmanship in international economic affairs. There should be no further delay in moving towards a comprehensive reform of the international monetary system which would secure the objectives of reasonable exchange and monetary stability and address itself to the special concerns of the developing countries. The convening of an international monetary conference with a development focus as suggested at the New Delhi meeting of the Non-Aligned Summit would be an important step in this direction.





TRANSFER OF RESOURCES TO DEVELOPING COUNTRIES:  
NATURE AND DIRECTION OF REFORM IN THE  
INTERNATIONAL FINANCIAL SYSTEM

M. Narasimham\*

I. INTRODUCTION

1. The last three to four years have witnessed a considerable deterioration in the position of the developing countries, particularly the non-oil developing countries. The global recession, coinciding with inflation in the major industrial countries, and the steep rise in the price of oil have combined to bring about a massive deterioration in their terms of trade, a weakened market demand for their exports and a decline in the prices of their export commodities. These developments have caused a regressive income transfer from developing countries to better-off countries, have seriously affected the developing countries' tempo of investment and growth, and have worsened their external account, as reflected in a marked widening of their current account deficit, which, in both 1980 and 1981, amounted to something over US \$ 100 billion. Although the preliminary figures for 1982 show some moderation in the current account deficit, it is still uncomfortably wide at an estimated US \$ 87 billion.

2. Unfortunately, the widening of the current account deficit has come at a time when its financing has become both costly and difficult. The excessive reliance of some major industrial countries, notably the United States of America, on monetary policies to combat inflation has led to real interest rates rising to historically high levels. It has been calculated that a 1 per cent increase in United States interest rates leads to an additional debt servicing burden of about \$ 3 billion for the developing countries that rely on international commercial banks to finance part of their current account deficits. Financing has not only become prohibitively costly; the apprehensions regarding excessive country exposure and the actions of banking regulatory authorities in major countries have also led to a marked slowing down of fresh resource transfers. As against an annual average of \$ 50 billion in the 1970s, net commercial bank lending is currently down to an annual level of \$ 10 billion. The international debt crisis that emerged in the autumn of 1982 was a predictable consequence of these developments. For the low-income countries which have little or no access to the capital markets, either on grounds of lack of creditworthiness to raise such monies or of their sheer inability to pay commercial rates of interest, the situation has been, if anything, worse. Concessional aid flows, on which these countries have traditionally depended have failed to grow adequately in real terms so that, in respect of several and, indeed of the majority

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of the countries, aid flows have hardly compensated for the serious income loss sustained by low-income countries following the deterioration in their terms of trade. The inadequate response of concessional aid flows has been attributed to budgetary constraints which have affected both multilateral and bilateral forms of concessional lending. The decline in the private component of lending has thus had its counterpart in an inadequate growth of the official sector in development finance. The translation of the balance-of-payments difficulties of developing countries into an acute development crisis has thus been primarily the result of the inability of the international financial system to cope satisfactorily with the payments pressures being experienced by the developing countries.

## II. THE MULTILATERAL LENDING AGENCIES - THE WORLD BANK

3. In 1980, the Management of the World Bank proposed that, keeping in view the rate of inflation, the increasing demands on the Bank's resources represented by the change in China's membership and the additional requirements of lending for the energy sector (to name but two of the more important), World Bank lending for the five-year period from financial year 1982 to 1986 should increase to \$ 90.5 billion from an earlier planned level of \$ 65 billion. This was no more than a realistic appreciation of the additional demands on the system, and accordingly received the support of developing countries as represented by the Group of Twenty-Four. On the other hand, there has been considerable opposition to this proposal from the majority of Part I countries contributing to IDA. Given the system of weighted voting, these proposals have therefore failed to receive approval. World Bank lending consequently has not shown the increase that is both desirable and necessary. In financial year 1982, Bank lending amounted to \$ 10.3 billion, and for financial year 1983 the programme is no more than \$ 11.2 billion. At currently projected commitment levels of IBRD, both net disbursements and net transfers would show a serious decline even in nominal terms. The decline is particularly sharp in terms of net transfers. An analysis carried out by IBRD itself indicates that commitment levels would have to increase by at least 6.2 per cent in real terms over the levels reached in financial year 1983, if net disbursements and net transfers are not to diminish further. Such a diminution would be particularly inopportune and inappropriate in the present environment for developing countries.

4. If the World Bank is to play even the modest role of sustaining the level of net disbursements and net transfers, an expansion of its capital base is called for. A further general capital increase will be needed by the World Bank to cover these requirements. Past experience has shown that a General Capital Increase is a tortuous and time-consuming process. However, as the situation is pressing, urgent consideration needs to be given to a special and selective capital increase. Such a selective capital increase could be pursuant to, and in line with, the recently agreed upon (but yet to be ratified) Eighth General Review of Quotas in the International Monetary Fund. An increase in the Bank's capital following a Quota Review of the Fund is not unusual. On the contrary, increases in the Bank's capital have generally followed

Quota Reviews in the Fund. If the Bank has to increase its commitment levels to the extent which the Bank itself considers necessary to preserve the levels of net disbursements and net transfers, an immediate enhancement of its capital resources is imperative. On the basis of the agreed Quota Review in the Fund, where quotas are to be enhanced by 47.5 per cent, one could think in terms of a Selective Capital Increase in the Bank of as much as \$ 35 billion. However, one must in all realism concede that this order of increase is unlikely in the short term. Nevertheless, it should not be less than at least \$ 20 to \$ 25 billion, which would permit the Bank to achieve an increase of about 5 to 6 per cent in real terms over the financial year 1983 level in the next few years.

5. The question relating to the Bank's capital increase is also related to a reconsideration of the question of the gearing ratio from the present level of 1:1 to 2:1, as was recommended, among others, by the Brandt Commission. The objection to an enhancement of the gearing ratio has been on the legal ground that this might involve a breach of faith with the bondholders of the Bank, who, it is claimed, may have been persuaded to subscribe to the bonds on the understanding that the financial strength of the Bank is based on the present gearing ratio of 1:1. It should not be beyond the ingenuity of the Bank to meet this objection by offering to redeem bonds from those bondholders who object to an enhancement of the gearing ratio, and by refinancing the bonds held by others who have no such objection; moreover, for the future, the Bank could announce the enhanced gearing ratio in the prospectus of the issues of bonds. An enhancement of the gearing ratio is called for if the Bank is to play the role expected of it in financing international development without too much reliance on governmental budgetary contributions to its capital resources.

### III. REGIONAL BANKS

6. The same arguments apply, *mutatis mutandis*, to the regional development banks. All of them have been suffering from a serious insufficiency of capital resources, and have the same disabilities concerning the gearing ratio. A specific instance, which reflects the difficulties faced by the regional banks in expanding their capital base, is the recent experience of the Asian Development Bank. Here, the Management and the developing country membership of the Bank were in favour of a capital increase of 125 per cent. However, owing to the opposition of some of the major shareholders of the Bank, the capital increase was limited to 105 per cent, which would constrain the ability of the Bank to expand its lending and widen the coverage of its borrowing membership. Having argued for a smaller capital increase, some countries are putting forward a specious argument about the need to preserve the entitlements of traditional borrowers vis-à-vis new borrowers - an argument for which, needless to say, there is no warrant, either in the Charter of the Bank or in the experience of other multilateral agencies such as IBRD or IDA.

7. While the limitations on capital resources get in the way of



increasing the amount of assistance provided by the World Bank and the regional development banks, there has also been, regrettably, some deterioration in the quality of assistance, not in the sense that the economic and technical criteria governing such lending are any less stringent or that the lending itself is any more lenient. On the contrary, without detriment to the techno-economic viability and other normal project appraisal criteria, there is a case for making the loans less of a burden to the borrowing countries at a time when the overall economic situation has deteriorated seriously largely owing to exogenous factors. The cost at which resources are being made available has increased with the adoption by the World Bank of the system of variable interest rates during the period when international interest rates were high. The reduction in the quantum of assistance has also been accompanied by a disturbing tendency to divert attention to issues such as the effectiveness of aid and the policy framework within developing countries. Project-specific conditionality has always marked World Bank lending, but sectoral and macro-conditionality is increasingly being applied.

#### IV. STRUCTURAL ADJUSTMENT LENDING

8. With the introduction of structural adjustment lending, the conditionality prescribed by the World Bank on macro-economic policies is coming very close to the type of conditionality prescribed by the International Monetary Fund. A fairly similar set of policy prescriptions relating to the operation of the pricing system, interest rates, exchange rates, the trade regime and the like, is increasingly in evidence. The growing collaboration between the Fund and the Bank could, in normal circumstances, be regarded as a welcome feature, but when one institution makes it a pre-condition for sanctioning loans or permitting tranche drawings that a country must arrive at an agreement with the other institution or satisfy the other in respect of important policy areas, borrowing countries tend to find that they have little outside choice, especially with the deterioration in the overall aid climate and the slowdown in commercial bank lending.

9. Structural adjustment lending was designed, as its name implies, to provide countries with a line of finance for a long enough period - beyond the normal period of the IMF's Extended Fund Facility - to effect necessary structural adjustments in their economies in the face of an irreversible shift in their balance of payments. Though structural adjustment lending is project untied, it is a far cry from the usual concept of programme lending, which developing countries have consistently pleaded for, and which has received the endorsement of such bodies as the Brandt Commission. The stringent conditionality which accompanies such lending deprives it of the flexibility and quick disbursement that one associates with the usual type of programme lending. If structural adjustment lending is to be significantly helpful in fulfilling the purpose for which it has been instituted, it is necessary that the type of conditionality prescribed be considerably moderated. This is not to say that the programme lending should be totally unconditional. It would not be realistic to ask for such a type of lending. What is suggested is that the conditionality be broad-based,

and country specific, rather than based on a standard mix of market-oriented policies on the supposed ground that these policies are better geared to provoking the appropriate supply responses. The alignment of policies with market forces does not fit in well with the wide diversity of the social and economic systems of the countries members of the international institutions. Such programmes or structural adjustment lending, with less emphasis on a standard pattern of conditionality, need not be restricted, as now, to a ceiling of 10 per cent of the Bank's total annual commitment. The Group of Twenty-Four had, in its 1979 document on "Outline of monetary reform", suggested a minimum of 25 per cent for programme lending. This figure has relevance even today. In addition, local cost financing should also be expanded.

#### V. SINGLE COUNTRY EXPOSURE

10. A further point relating to the World Bank's lending policy is the present convention of limiting single country exposure to a cumulative total of 8-10 per cent of the Bank's lending totals. This could have the unintended and, indeed, undesirable effect of placing a limit on the Bank funds available to countries which are in a position to absorb more while leaving funds relatively idle with the Bank which would, by implication, be reserved for other countries which have not reached this cumulative total, but whose absorptive capacity may not be equal to the Bank funds to which they are entitled. While the prudence associated with the principle of limiting country exposure may have some justification, a flexible attitude in this matter is called for.

#### VI. GRADUATION

11. A related point is the World Bank's policy with regard to graduation of countries. At a time when the private capital markets are tending to be increasingly hesitant in extending credits to middle-income and newly-industrialized countries, a rigid application of the formula of graduation cannot but have deleterious consequences for them. There is, therefore, need for alternative approaches to avoid the premature phasing out of the countries concerned until they are better able to secure a continuous flow of resources from the capital markets and until the markets themselves recover a degree of balance between their earlier extreme laxity and their recent rigid conservatism.

#### VII. CO-FINANCING

12. The growing trend towards the privatization of resource flows and the ideological pressures being brought to bear on the World Bank by countries dominant in its system of weighted voting towards forcing countries to rely more on the private banking system are reflected in the Bank's recent enthusiasm for co-financing. Co-financing has a legitimate role to play, but to be meaningful it has to represent a genuine additionality of resources and in any case should not become a precondition for Bank lending. Furthermore, one should respect the

sensitivity of the borrowing countries which may agree to a type of conditionality imposed by an international institution which they would resist when suggested by a commercial organization. Co-financing in respect of structural adjustment lending is particularly subject to this limitation. Formerly, the case for co-financing seemed to rest on the perceived inadequacy of the Bank's own resources. Now, co-financing is being projected as a means for the Bank to play a catalytic role to induce commercial banks to lend in an otherwise restrictive capital and credit market. In the 1970s, a considerable part of commercial bank credit, whether for general balance-of-payments support or for projects, was relatively free from conditionality. If co-financing is, as one suspects, not going to contribute very significantly by way of additionality, developing borrowing countries will be subject to the double disadvantage of inadequate resources and the stipulation of conditions. As for low-income countries, co-financing has little attraction unless schemes could be devised to provide interest subsidies by official agencies on commercial bank debts. 1/

#### VIII. INTERNATIONAL DEVELOPMENT ASSOCIATION; THE EXPERIENCE OF IDA VI

13. Nothing is more reflective of the current unsatisfactory state of international development finance than the trials and tribulations through which the Sixth Replenishment of IDA (IDA VI) is passing. IDA VI was, like the earlier replenishments, supposed to be for a three-year period ending in financial year 1982/83. It was clear soon after its commencement that - quite apart from the impact of inflation - the original sum of \$ 12 billion would be inadequate in relation to the emerging needs of China (which had taken its rightful place among the membership of the Bank and IDA), the additional sums required for lending for the energy sector in the low-income countries (the urgency of which was brought home by the structural nature of balance-of-payments adjustment required by the non-oil developing countries), and the growing needs of Sub-Saharan Africa, which had witnessed hardly any growth in the 1970s. In the event, however, obtaining even this relatively modest amount has proved difficult. The United States, whose share at 27 per cent in IDA VI, incidentally, was less than in any previous replenishments, found itself unable to contribute its share, with the result that IDA VI had effectively to be extended to financial year 1983/84 in the form of a bridging arrangement. Even with this extension, the fulfilment of the original \$ 12 billion would be contingent upon the United States contributing \$ 1.095 billion in 1983/84, to make up its aggregate share of \$ 3.24 billion originally

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1/ A government-financed interest subsidy scheme for commercial bank lending would help to catalyze more funds for low-income countries and provide the banks with some degree of assurance on such lending. It would represent a wider extension of the earlier Horowitz proposal. (The Horowitz Proposal: a plan for financing economic development of the developing countries (IBRD, 1965).)



committed to IDA VI. Fortunately, however, several donor countries responded to the shortcoming of the United States by not insisting on their pro rata contribution and thus helped to break what threatened to become a deadlock in respect of IDA in 1982/83.

14. A similar exercise, through other countries making parallel special arrangements, is expected in 1983/84. Overall, IDA VI has fallen short, by almost a third, of the original expectation of an annual commitment of \$ 4 billion.

#### IX. IDA VII

15. The experience with IDA VI serves as a warning in considering the prospects for IDA VII. While it is clear that the seventh replenishment should represent a substantial increase in real terms over the negotiated level of IDA VI, no agreement is yet in sight. Even to maintain in real terms a commitment level equivalent to the \$ 12 billion of IDA VI, it has been calculated that an IDA VII of not less than \$ 16 billion would be needed. This, incidentally, is the minimum target that has been set by the World Bank. On the other hand, the present indications are that the United States is not prepared either to go beyond a proportionate share of 25 per cent or to contribute more than \$ 750 million annually. The arithmetic of this would yield an IDA VII of \$ 9 billion, which would be totally inadequate and would mark a serious retrogression and signal failure by the international community to respond to the urgent and pressing needs of the low-income developing countries. It may well be that the reported United States stance is an initial negotiating position. However, every effort would be necessary to persuade the United States to increase its share to at least the level that it contributed to IDA VI, i.e. 27 per cent, and to aim at obtaining the World Bank minimum figure of \$ 16 billion to be committed over a three-year period. In the past, every successive replenishment has been larger in nominal and often in real terms than the previous one. The worsened international economic situation calls, if anything, for IDA VII to be larger even than what the Bank has proposed.

#### X. QUALITY OF IDA CREDITS

16. Not only is it of vital importance to obtain the minimum quantum of resources in IDA VII mentioned above, but it is equally necessary to maintain the integrity of IDA. There have been some suggestions that the terms and conditions of IDA credits need changing. It has been argued that, although the needs of the low-income developing countries for concessional funds have increased many times, the political support necessary for increasing IDA contributions has declined, not only because of domestic budgetary constraints and the higher cost of borrowing for donor countries, but also because of a perception that some IDA countries have progressed economically to a stage where it is not possible to justify highly concessional assistance to them. Accordingly, one suggestion has been that there should be a differentiation in the terms and conditions of credits made available



to recipient countries. Two kinds of IDA credits have been proposed, namely: (a) for creditworthy countries considered capable of bearing harder terms, credits would have a maturity of 25 years, with a seven-year grace period. Interest rates would be 3 per cent during the grace period and 6 per cent thereafter. The existing commitment fee and service charges would continue; and (b) for poorer countries, terms and conditions would be 35 years' maturity (as against the present 50 years) with a ten-year grace period. No interest would be charged, but the commitment fee and service charge would continue, as above.

17. The criteria for classifying countries into so-called "creditworthy" and "poorest" would be to ascertain whether the per capita income of the country is above or below \$ 405 in 1981, the degree of their independent access to intermediate and long-term commercial funds in capital markets, and finally, whether or not the share of the manufacturing sector in their gross domestic product exceeds 15 per cent.

18. This attempt at differentiating IDA recipients is unwarranted, and goes against the very philosophy of IDA which has had, and should continue to have, a poverty focus. The suggested cut-off point of \$ 405 is low enough to qualify a country for being considered poor, and therefore worthy of IDA assistance. To attempt to differentiate between such poor countries on the basis of their supposed ability to have access to intermediate and long-term commercial funds or on the basis of the importance of the manufacturing sector in their economies has little logical validity. IDA was conceived as a vehicle of assistance to low-income countries because of the recognition that they would find it difficult to service debts on commercial terms. In the present world economic situation, when the balance-of-payments problems of the low-income oil-importing countries continue to be serious, any dilution of the quality of concessional assistance in the manner proposed could only add to their problems. Furthermore, for low-income countries there are clearly limits to the access that they may have to commercial markets, if they are not to be over-burdened with the problems of debt servicing. In any event, the World Bank has already instituted the system of providing Bank money in combination with IDA credits to certain countries - the so-called "blend" countries - and if it is thought that some of these countries would be in a position to absorb more of Bank, as distinct from IDA, resources up to a point, that possibility exists without having to differentiate between the diverse IDA recipients. Nor is there much justification for the criterion of the proportion of manufacturing industry in the economy. Several IDA recipients, and some of the largest among them - such as China, India, Pakistan, among others - have manufacturing industry contributing 15 per cent or more of their GDP. Indeed, some of them had attained this proportion even at the time IDA was conceived and established. To bring in this criterion now would seem to equate development with industrialization. Development is much too complex a process to be reduced to simplistic formulas such as an arbitrary proportion of manufacturing to gross domestic product.

19. There is thus no case for departing from the established and accepted criteria for IDA eligibility, namely, low per capita income and the inability to service debts in the amounts required on commercial

terms, referred to - not quite accurately - as "lack of creditworthiness". The criterion of per capita income, while admittedly inadequate, is certainly more relevant in understanding the problems of a low-income country.

20. The argument for differentiation or for hardening IDA terms rests, supposedly, on the perception that such changes might help to attract more resources to IDA, by way of tapping non-traditional sources of funds, including low-cost borrowing from governments, as distinct from budgetary grants. There is no warrant for assuming that if budgetary constraints were the real reason for donors not contributing adequately to IDA, they would be more inclined to do so by way of low-interest loans rather than grants. In short, while the additionality of funds is hypothetical, the higher cost to the borrowers could be real.

21. The problems of IDA financing have been ascribed to budgetary constraints in the major donor countries. The fact remains, however, that contributions to IDA represent but a small fraction of the budgetary deficits. On the other hand, the advantage which the donor countries reap by way of additional job opportunities and expanded levels of exports are important in the context of the recession through which many major countries have recently been passing. Conceding for the moment, however, that at the margin any addition to their budgetary deficit through more IDA contributions would be resisted by the major donors, an interesting suggestion has been made that, if the major countries agreed to SDR allocations, they could then turn over part, or where necessary, the whole of such SDR allocations as their IDA contributions. 2/ With the abatement of inflationary pressures, the argument against fresh SDR allocations - which was never strong in any case - has certainly weakened much further, and if the surplus countries, which are not likely to use SDRs on their own account, were to use them instead as their IDA contributions, it would have the effect of expanding world liquidity, the global need for which has been well established, provide needed transfer of resources to developing countries without placing a burden on the budgets of the major donor countries, and help expand world trade and strengthen economic recovery.

22. The past record of IDA has shown its value and importance to low-income countries. IDA credits have passed the strictest tests of project approval and viability and proved that concessional lending is not soft, as the President of the World Bank has remarked, in terms of criteria of appraisal or viability of the projects financed.

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2/ This suggestion, which can be regarded as a variant of the earlier Maxwell Stamp proposal on the SDR-aid link has been made by Mr. L.K. Jha, a Member of the Brandt Commission.

## XI. OFFICIAL DEVELOPMENT ASSISTANCE

23. The insufficient funding of IDA is part of the largest problem of the inadequate growth in real terms of official development assistance (ODA) in recent years. Along with concessional multilateral lending such as IDA, bilateral official development assistance has suffered. The inadequacy of ODA flows has stood out in sharp contrast against the depressing background of the worsening of the external accounts of low-income countries owing to the impact of global recession, increased protectionism, worsening terms of trade, all of which have contributed to a slowdown of investment and growth. Low-income countries suffer from a set of interlocking structural handicaps and are particularly vulnerable to the type of adverse changes in the international environment that have taken place recently. Their capacity to adjust to exogenous destabilizing influences is limited by institutional, infrastructural and human resource constraints. ODA is particularly well suited to support their efforts at structural transformation. It is therefore all the more regrettable that when the need has proved greater, the response of the international community has become weaker.

24. In 1981, ODA from members of the OECD Development Assistance Committee (DAC) declined from the figure of earlier years and amounted to \$ 25.6 billion, largely representing their inadequate contribution to IDA. There has been a modest reversal of this trend in 1982, with the provisional figure estimated at \$ 27.9 billion. Nevertheless, ODA is still far short of the internationally agreed target of 0.7 per cent of GNP, with only some OPEC countries and the Nordic countries and the Netherlands among the DAC countries having fulfilled the target. In 1981, ODA in the aggregate was just half of this figure at 0.35 per cent, and in 1982 it was 0.39 per cent. The increase, as noted above, in 1982 reflects the decline in the earlier year and some correction to this decline in the latter year of contributions to IDA. Though the annual rate of increase in aid in real terms has risen slightly in the most recent period, as a proportion of GNP, the situation has not improved since the early 1970s. Furthermore, whereas in 1970 ODA flows accounted for 43 per cent of the total net flows of funds of DAC countries, it was no more than 30 per cent in 1982, reflecting the increasing resort by these countries to a mix of concessional and non-concessional funds in their aid programmes. The recent UNCTAD VI Conference has urged those developed countries that have not yet reached the internationally agreed target of 0.7 per cent of GNP to redouble their efforts to achieve this target by 1985, and in any case, not later than in the second half of the decade. The Conference also recommended that each developed donor country should establish its own programme and make binding commitments for the annual growth rate of ODA disbursements, so as to result in a general increase of ODA in real terms and in improvement in the quality of lending.

25. ODA has been, and will continue to have to be, a major source of external assistance to low-income countries. It is necessary, as the World Bank in its very first World Development Report pointed out, that the availability of external assistance should be put on an assured, continuing and predictable basis, in order to enable national



authorities to plan their investments in a more rational and assured manner.

26. An important aspect of ODA relates to its distribution. There has, in recent years, been a perceptible shift away from multilateral towards bilateral forms of ODA. Where bilateral aid is more prominent, considerations other than strictly economic ones enter the calculations. Strategic, political or commercial considerations often influence ODA distribution. In the process, many needy low-income countries get far less than their proportionate share would suggest or than they need. In view of the serious situation of the least developed countries, it would be desirable, and indeed, necessary, to stipulate that a minimum percentage of ODA in relation to GNP should flow from the donor countries to this group of disadvantaged countries. The Non-Aligned Summit Meeting, held at New Delhi in March 1983, recommended in this context that 0.15 per cent of GNP should go as ODA for the least developed countries, and that this target be reached by 1985. UNCTAD VI has subsequently made a similar recommendation.

27. ODA is increasingly taking the form of concessional loans and tied credits. Some countries such as the Nordic countries, the Netherlands, and the United Kingdom, have put their ODA to low-income countries entirely on a grant basis, and this example is worthy of emulation by others. Furthermore, there has been an increasing tendency to rely more on country-tied and project-tied assistance. In the difficult circumstances in which the developing countries find themselves, a degree of flexibility, at least in the matter of project-tied and local cost financing, would be necessary.

## XII. PRIVATE CAPITAL FLOWS

28. The constraints with regard to official financing of resource transfers to developing countries that have marked the most recent period have been matched by a similar, and sharper, slowdown in lending by the international commercial banks. The privatization of international capital flows was one of the more significant developments in the 1970s, and following the emergence of surpluses with the oil-exporting countries, the international banking system successfully recycled these surpluses to borrowing countries, many of which were developing countries, which were thus able to finance their wider current account deficits in this fashion. It has been estimated that a little under half of the current account deficit of the non-oil exporting developing countries was financed through the commercial banking system. The flow of commercial bank lending went naturally to those countries that could afford to pay higher rates of interest and favoured the middle-income and newly-industrialized countries. Even among these, the distribution was highly skewed in favour of a few countries, with five large borrowers accounting for more than half the total. The period following the second oil price increase, with its aftermath of international inflation and global recession, has witnessed a marked slowdown in such lending, with increasing apprehensions relating to country exposure. The banks have become more



selective in choosing their customers and projects, and less liberal in providing general balance-of-payments support. Maturities have tended to become shorter. Meanwhile, the rise in interest rates reversed the earlier phase when much borrowing was made on negative real interest rates. Interest rates reached unprecedented high levels, both in nominal and real terms, in 1981 and 1982, leading to serious problems in servicing the rapidly accumulating commercial debts. The emergence of the international debt crisis was a natural consequence of a cumulative level of international commercial bank lending of over \$ 500 billion, and the high interest rates that had to be paid to service this huge debt.

29. The privatization of capital flows has revealed the instability and the potential fragility of the international financing system. There has been, in consequence, increasing recourse of official funding - in this case, the IMF - which has played a catalytic role. It is a moot point whether the banks are being bailed out by the Fund, or, as the latter likes to believe, the banks are being bailed in. What the recent experience, however, emphasizes is the need for more official resource transfers, preferably through multilateral agencies, not only to catalyze bank lending, but, in fact, to substitute an increasing proportion of it. The increasing recourse to official agencies by countries which hitherto put their main reliance on the private markets has come at a time when the resources of these agencies themselves are under strain. The tightening of IMF conditionality to all borrowers must be seen as an aspect of the pressures on the Fund's liquidity by the addition to its list of borrowers of these countries seeking its catalytic role in their negotiations for debt rescheduling and fresh borrowing from the commercial banks.

### XIII. DIRECT FOREIGN INVESTMENT

30. In the current economic situation, it would be unrealistic to expect that direct private foreign investment would make any but a marginal impact on resource transfers. The traditional areas where such investment has flowed in the past, namely, Latin America and some of the countries of South and East Asia, have witnessed a decline in fresh investment flows which, once again, may be regarded as an aspect of the downturn in global economic activity. With the incipient signs of economic recovery gathering strength, one might hope for some recovery in private investment flows also, but, as stated earlier, it would be unrealistic to expect any dramatic improvement or any significant difference to the overall resource flow problem. In fact, the problems here are related to the wider range of issues connected with the operations of transnational corporations. It is worth noting that, in their anxiety to attract direct foreign investment, several countries have adopted policies of providing incentives in relation to tax and other benefits, with the result that there has been competitive incentive giving, the net effect of which is to neutralize the differential advantage which any individual recipient country may be offering, but which, in sum, tends either to effect transfers from the treasuries of developing countries, to the treasuries of the source countries or to add to the profits of the transnational corporations.

Developing countries would be well advised to examine the implications and impact of such policies of providing incentives which do not, in sum, benefit them as a group, and indeed, deprive them of needed resources.

#### XIV. INTERNATIONAL FINANCE CORPORATION

31. In connection with direct foreign investment, a reference may be made to the International Finance Corporation. This institution, affiliated as it is to the World Bank, represents a multilateral approach to the problem of providing risk capital and deserves strong encouragement. The capital base of the International Finance Corporation was recently enhanced, but again, given the potential of this organization and the large energy needs, a further strengthening of its capital resources would clearly be in order.

#### XV. ENERGY LENDING

32. One of the factors behind the increased demand for resource transfers, particularly with a view to bringing about a degree of structural adjustment in the balance of payments of oil-importing developing countries, is the necessity and importance of enlarging and strengthening their energy sector. The World Bank has calculated that the energy investment requirements of developing countries are of the order of \$ 1,300 billion for the rest of the decade. However, given the resource constraints which the multilateral banks themselves are facing and the very many pressing demands on these resources, their ability to make anything more than a marginal impact is obviously limited. It is not, also, clear or even likely that the private capital markets and private oil companies would be inclined or willing to seek to explore energy sources in a large number of developing countries, where the scale of operations might be small for them, but where the impact of successful exploitation would, however, be significant in individual countries in terms of the positive gains to their balance of payments. This is part of the rationale for an enlargement of official financing of investment on a multilateral scale in the energy sector. The World Bank had earlier noted a proposal for an expanded energy programme, and had suggested the possibility of setting up an energy affiliate or Pool or a Trust Fund for Energy. These ideas have certainly not lost their relevance. The recent softening of oil prices may well be reversed with an upswing of world economic activity. In any event, for many oil-importing developing countries, the need for structural adjustment requires not only exploration and development of potential hydro-carbon resources, but, equally significantly, the development of other conventional and non-commercial sources of energy. Such an expanded programme of developing energy resources and promoting energy conservation would call for a large measure of official international financing. The precise modalities are not so important as the recognition of the need for such financing, and a determination to find appropriate means of providing such finance.

## XVI. CONCLUSION

33. There is international agreement that, in an interdependent world, the acceleration of development in the developing countries is important, not only for its own sake, but for its beneficial impact on the developed countries themselves. Despite this recognition, the recent record in respect of resource transfers has been disappointing. The developing countries have not gained in additional assistance what they have lost through the deterioration of their terms of trade and the higher cost of borrowing as a result of higher interest rates. This has inevitably aggravated their problems and their ability to sustain the tempo of their investment and growth. Today, the surpluses of the oil-exporting countries have all but disappeared, while the deficits of the non-oil developing countries remain nearly as large as they were three years ago. The surpluses now rest with the major industrial countries whose ability to transfer resources has not, unfortunately, been matched by a willingness to do so and, thereby, to assist the process of a broad-based international economic recovery. The task is one of generating the requisite political will in the major industrial countries - a task which, one hopefully assumes, will be less difficult if the recent signs of economic recovery are sustained and strengthened, and the budgetary constraints consequently eased.

PART I:

INTERNATIONAL DEBT RESCHEDULING SINCE MID-1982:  
RESCUE OPERATIONS AND THEIR IMPLICATIONS FOR  
COMMERCIAL BANKS AND DEBTOR COUNTRIES

Paulo Nogueira Batista, Jr.

and

PART II:

INTERNATIONAL FINANCIAL RESCUE:  
VIABILITY AND MODALITIES

William R. Cline

INTRODUCTION

Considerable interest attaches to the international rescue operations in the financial field undertaken from mid-1982 onwards. It was therefore decided to invite two experts with somewhat different points of view to review the course of these operations and make an evaluation of their effectiveness. The two authors invited to undertake this task are Mr. Paulo Nogueira Batista, Jr., Research Economist, Centre for Monetary Studies and International Economics, Rio de Janeiro, and Mr. William R. Cline, Senior Fellow, The Institute for International Economics, Washington, D.C. Their papers are now being made available to the Group of Twenty-Four within the covers of the present document.

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## PART I

INTERNATIONAL DEBT RESCHEDULING SINCE MID-1982:  
RESCUE OPERATIONS AND THEIR IMPLICATIONS FOR  
COMMERCIAL BANKS AND DEBTOR COUNTRIES

Paulo Nogueira Batista, Jr.

I. Introduction

1. Over the last two years, emergency financial assistance has been provided on a case-by-case basis to a large and increasing number of countries that have experienced severe debt-servicing problems. As is well known, these so-called financial rescue operations, combined with IMF-sponsored adjustment programmes, were put together in response to the crisis that broke out in full force after Mexico announced its first ninety-day moratorium in August 1982. An announcement that immediately affected several dozen debtor countries in Latin America and in other regions of the world. Despite a series of false starts and disruptions, and despite the open resistance of some important debtor countries such as Venezuela and more recently Argentina, a general pattern of short-term crisis management has emerged over the last two years, the basic purpose of which is to allow internationally exposed commercial banks and "problem countries" to overcome the difficult transition to an expected scenario of sustained economic growth and lower interest rates in the industrialized countries. These rescue operations were therefore clearly conceived as a way of providing temporary financial assistance to countries experiencing a supposedly temporary inability to service their foreign debts.

2. The basic purpose of this study is to examine and discuss, from a number of different points of view, the main features and results of the financial rescue operations undertaken since mid-1982. The view taken in this paper is on the whole critical of the way international debt problems have been handled in the recent past. It will be argued that the overall structure of so-called rescue operations is highly unsatisfactory not only from the viewpoint of the debtor countries but also from that of a majority of commercial banks involved in international lending. The recent further rise in United States interest rates, the Cartagena meeting, the apparent impasse between the IMF and Argentina, Venezuela and other Latin American countries over debt rescheduling and negotiations have made a critical discussion and re-examination of the issues all the more relevant. In fact, rising international interest rates and doubts as to the sustainability of the economic recovery now in progress in the United States and other industrialized countries clearly pose a threat to the financial rescue operations in their present form. The sharp reduction in domestic income and employment in the debtor countries and the extreme uncertainty about the prospects for a significant economic recovery of these countries have indeed placed severe strains on the viability of current adjustment schemes.

3. This paper is divided into three major sections. Section II

focuses on recent efforts at crisis management, briefly examining the main features and basic aims of rescue operations. Section III is dedicated to a discussion of the vulnerability of the major United States banks and its relationship to current rescheduling practices, emphasizing the existence of significant divergencies of interest between these major United States banks and banks of a different size and/or nationality. In Section IV the international debt crisis and financial rescue operations are examined from the point of view of developing countries, with a special emphasis on the specific problems of Latin American debtors; emergency financial assistance is shown to have been provided in such a way as to force debtor countries to take on the major share of the costs involved in managing the current debt crisis. The final section outlines the main elements of an extended debt restructuring scheme that would be a viable alternative to current arrangements; it is argued that wide-ranging restructuring operations, involving capitalization of interest, a drastic reduction in spreads, and an extension of maturities and of debt consolidation periods, may in some cases be the only effective way of creating the conditions for an eventual return of debtors now experiencing debt-servicing disruption to voluntary borrowing in international financial markets in the early 1990s.

## II. Crisis Management Since 1982: The General Structure of Rescue Operations

4. Since mid-1982, the free operation of international financial markets, i.e., the extension of credit on an essentially voluntary basis, has been to a large extent replaced by a centralized lending system that involves debt restructuring and the negotiation of special new loans under IMF and/or government pressure. These so-called rescue operations take the form of short-term financial packages which combine rescheduling (in some cases refinancing) of principal payments with new bank credits in the form of "forced" or "involuntary" lending to countries going through debt-servicing crises.

5. In 1983, almost half of total new medium-term Eurocurrency bank credits to developing countries consisted of special new loans negotiated in the context of debt restructuring and IMF adjustment programmes. In the case of Latin America, less than 10 per cent of last year's total Eurocurrency bank credits can be considered normal market transactions. <sup>1/</sup> For eleven major debtor countries in Latin America, Eastern Europe and Africa, the amount of bank debt rescheduled in 1983 reached more than \$US 40 billion, and eight of these countries obtained a total of about \$US 14 billion in additional credits under the new system of forced lending (Table I.1).

6. These rescue operations were put together with the conscious purpose of containing within certain limits the violent contraction of international credit flows unleashed by Mexico's moratorium in the third quarter of 1982. Some form of official intervention became in fact indispensable. Simultaneous disruption of debt-servicing in a large number of major countries in Latin America, Eastern Europe and other

regions constituted a significant threat to the stability of the banking system in the industrialized countries. Given their high level of exposure to debtors experiencing balance-of-payments crises, the vulnerability of some major international banks, especially in the United States, was clearly an extremely serious problem.

7. A justified concern with the potential impact of the debt crisis on major international banks has been the driving force behind the series of rescue packages implemented in the recent past. In fact, the nature of these operations cannot be well understood if this basic aspect is not taken into account.

Table I.1 - Major Bank Debt Reschedulings in 1983  
(millions of dollars)

Country	Amount rescheduled	New money
Argentina	7,000	1,500
Brazil	4,800	4,400
Chile	3,400 <u>a/</u>	1,300
Ecuador	1,970 <u>b/</u>	431
Mexico	21,500 <u>c/</u>	5,000
Nigeria	1,830 <u>d/</u>	-
Peru	380	450
Poland	1,000	- <u>e/</u>
Romania	572	-
Uruguay	693 <u>a/</u>	240
Yugoslavia	1,020 <u>f/</u>	600

Sources: International Monetary Fund, Recent Multilateral Debt Restructurings with Official and Bank Creditors, Washington, D.C., December 1983, Occasional Paper No. 25, pp. 30-42; Organisation for Economic Co-operation and Development, Financial Market Trends, November 1983, No. 26, p. 37.

a/ Includes rescheduling of non-trade-related short-term debt.

b/ Includes refinancing of \$US 670 million of short-term debt.

c/ Includes settlement of interest in arrears on private sector's debt.

d/ Rescheduling of arrears on letters of credit.

e/ A six-month trade credit, revolving up to five years, was extended under separate agreement; the amount of the credit was equivalent to 65 per cent of the \$US 0.3 billion in interest due on outstanding obligations other than those arising from the 1981 and 1982 reschedulings.

f/ Refinancing of principal repayments on certain types of medium-term debt.

8. When the international financial crisis broke out in full force in the wake of the Mexican moratorium, it became almost immediately clear that a complete breakdown of debt-servicing in a large number of countries could not be avoided without a minimum of emergency financial assistance to debtors affected by the sudden and unexpected collapse of international bank credit. At the same time, approval by the IMF of an adjustment programme was made a precondition for any formal financial agreement with official and bank creditors.

9. ... It was not to be expected, however, that the Fund's famous "seal of approval" would automatically restore the supply of capital from private sources to acceptable levels. Given the size and structure of debts accumulated over the previous ten years and the extraordinarily high level of international interest rates, the IMF was virtually forced to take on a new role. Besides attempting to ensure the adoption of "adequate" adjustment policies by debtor countries, the Fund has also insisted that banks provide a certain level of external financing through rescheduling and new money in the form of "forced" loans. 2/

10. The contribution of each individual bank to these new money facilities is established on the basis of its share of total bank exposure at a particular moment in time. 3/ In the absence of defections and exchange-rate changes, the nominal exposure of all creditor banks would therefore grow at exactly the same rate.

11. For banks with particularly heavy exposures in "problem countries", the extension of additional loans is simply a way of protecting the value of outstanding credits and of sustaining the confidence of their own creditors and shareholders. But leaving aside money-centre banks in the United States and a number of heavily exposed institutions in other industrialized countries, the international banking community as a whole has shown an understandable reluctance to participate in new credits to countries that have been unable to continue servicing their foreign debts. In this context, the attempt to ensure wide-ranging bank participation has led debtor countries to offer extremely high rates of interest in rescheduling and new money deals. Preliminary estimates suggest that operations recently concluded between Brazil and its bank creditors, for instance, carry an effective spread of about 4 percentage points. 4/

12. Nevertheless, recent experience seems to have shown that the readiness to pay extremely high spreads does not by itself guarantee the required volume of bank financing. A large number of banks would have probably refused to participate in new loans had they not been subjected to substantial direct pressure by major international banks, by the IMF and by governments or central banks of creditor countries. This pressure seems to have been an important factor in overcoming the resistance of banks with lower levels of relative exposure.

13. It should not be forgotten, however, that the successful conclusion of a series of forced loans over the last two years was also made



possible by the relatively modest amount of financing provided in these operations. In fact, the supply of new bank loans corresponds to a fraction of the interest payments that banks expect to receive. In the case of Brazil, for example, the amount of new money provided through "jumbo-loans" in 1983-84 covers only about one half of the interest due to the banks in this period. 5/

14. The Fund's Managing Director has repeatedly emphasized that one of the basic assumptions underlying current rescue operations was that banks would be willing to allow their nominal net claims on developing countries to grow at an annual rate of about 7 per cent in 1983. 6/ The volume of bank lending in 1983 seems to have been broadly consistent with attainment of this target, a fact that has led Jacques de Larosière to praise the international financial community's pragmatic response and "high sense of responsibility". 7/

15. Bank co-operation in these recent financial arrangements has of course little to do with their "high sense of responsibility" and reflects in reality the self-preservation instinct of major international banks, extremely high spreads and the direct pressure applied to smaller and/or less exposed banks. It must be stressed, moreover, that a 7 per cent increase in bank exposure amounts to a drastic reduction in the rate of growth of international bank credit.8/ Although the underlying criteria were never openly stated, this target seems to have resulted from a deliberate attempt to initiate a gradual reduction of the relative exposure of banks in "problem countries". In fact, some decline in the ratio of outstanding loans to bank capital plus reserves must have already occurred in the recent past. From December 1977 to June 1982, reporting banks in the United States increased their total capital at an average annual rate of 11.3 per cent. 9/ Under pressure from supervisory authorities, the ten largest banks in the United States are reported to have increased their equity by an average of 16 per cent in 1983. 10/ Assuming 7 per cent growth in the level of absolute exposure to "problem countries", the relative exposure of those ten banks in these countries must therefore have declined by about 8 per cent in 1983.

16. This initial result can be seen as the first step in a conscious attempt to reduce the heavy exposure of major international banks over the medium-term. In the case of Brazil, for instance, current adjustment policies and balance-of-payments targets seem to have been formulated with the specific purpose of allowing a continuous reduction in the nominal rate of growth of bank exposure. According to projections made in early 1983 by the Fund's technical staff, the outstanding commitments to Brazil of foreign banks would grow by 6.3 per cent in 1983, 5.4 per cent in 1984 and 4.5 per cent in 1985. 11/ In fact, the Fund seems to expect that Brazil will somehow be capable of stabilizing her bank debt well before the end of this decade. 12/ In this case, interest payments due to bank creditors would have to be wholly financed through net exports or net transfers from other sources of capital.

17. Given the high level of international interest rates, the planned reduction of relative bank exposure can only occur at the expense of the debtor countries. This fact has been explicitly recognized by the Government of the United States.

It was only as part of a co-operative effort among the debtors, banks, industrialized country governments, and the IMF that the debtor countries were able to get through the year [of 1983]. ... By far the greatest share of the burden was borne by the debtors themselves. ... [Argentina, Brazil and Mexico] have had to suffer severe recessions in order to reduce expenditure on traded goods. Real GNP has been falling rapidly. In these and other countries, unemployment is very high, and the standard of living of most of the population, including the middle class, has deteriorated sharply. Calls for solutions to the debt problem through adjustment by the debtor countries must acknowledge the fact that an enormous amount of adjustment is already taking place. 13/

18. With interest rates (including spreads and other charges) in the range of 14 per cent or 15 per cent and bank debt growing at annual rates of 7 per cent or less, the inevitable result is of course a massive transfer of resources from the debtor countries to the banking system. Without a strong and sustained recovery in the industrialized countries, this outward transfer will produce a lasting negative effect on growth and employment rates in debtor countries and/or destabilizing attempts to ensure drastic changes of relative prices in favour of tradeable goods.

19. In fact, the very feasibility of adjustment programmes based on the assumption of a wide and probably increasing gap between interest rates and debt growth depends crucially on the strength and sustainability of the economic recovery initiated by the United States in 1983. This recent recovery has undoubtedly played an important part in improving the context in which recent rescue operations have been carried out. But it may also have had the negative collateral effect of consolidating the predominance of a relatively complacent and passive attitude towards the costs and risks of the international debt crisis. The view that industrialized countries may be able to sustain relatively high growth rates over the next few years and that adjustment in debtor countries may therefore be able to proceed in a more favourable external context seems to have increased support for current rescue operations and to have reinforced the prevailing tendency to reject more ambitious and possibly more realistic debt restructuring schemes. In any case, the chronic imbalance of the public sector in the United States and in most other industrialized countries will tend to work against the acceptance of debt restructuring arrangements that involve the use of government resources or government guarantees. Any proposal that can be interpreted as an attempt to "bail out" the banks with public funds will of course run up against serious political resistance. In this context, wide-ranging restructuring schemes will only be seriously considered in the event of an unforeseen worsening of the situation.

20. It should be kept in mind that in the United States, Europe and Japan concern with the debt crisis has been to a large extent focused on its implications for the international financial system, while the effects on the economic conditions of debtor countries have remained clearly in the background. Short-run crisis management has been basically geared towards buying time, in the hope that higher levels of activity and employment in the industrialized countries and the resulting revitalization of international trade would eventually permit debtor countries to generate the required outward transfer of resources at higher levels of foreign trade and domestic absorption.

21. In the transition to this scenario of sustained growth in the industrialized countries, the response to the severe balance-of-payments problems of dozens of developing countries in Latin America and elsewhere consists of a series of tight-fisted financial packages, characterized by extremely limited amounts of financing, high costs and short consolidation periods, and constructed with the apparently deliberate purpose of keeping unreliable debtors on a "short-leash".<sup>14/</sup>

22. This so-called short-leash approach, typical of recent rescue operations, is seen, on the one hand, as a way of forcing debtors to adjust their external accounts as quickly as possible. In fact, creditors tend to believe that in the absence of pressure resulting from severe balance-of-payments problems debtor countries would not be prepared to accept the need for rigorous adjustment policies and lower rates of growth of debt. This point of view was expressed in an already quoted recent report of the Government of the United States:

One way to ease the burden on the debtor countries would be to increase the level of financing, and thus allow them to import more. The obvious drawback to allowing too high a level of financing is that it leaves the accumulated debt that much higher at the end of the year and reduces the pressure on the country to adjust.<sup>15/</sup>

23. Another reason for the preference for the so-called short-leash approach may be the perception that higher levels of financing may allow debtors to restore their level of liquid reserves and thereby increase their bargaining power.<sup>16/</sup> Although perfect control is not always possible in practice, there does seem to be a tendency to keep rescue operations as tight as possible with a view to avoiding the risks associated with any substantial improvement in the level of reserves of countries experiencing debt-servicing disruption.

### III. The Vulnerability of Major Banks in the United States and the Divergences of Interest Between Banks of Different Size and Nationality

24. The structure and potential weaknesses of recent rescue operations cannot be fully understood without taking into consideration the specific problems faced by the large United States banks and the



divergences of interest between the latter and the majority of banks involved in international lending. Despite the emergence of a general pattern of crisis management over the last two years and despite the leading role played by the large United States banks in setting up emergency financial support for debtors experiencing severe balance-of-payments difficulties, there should be no doubt as to the existence of significant differences between their approach to debt rescheduling and that of banks from other industrialized countries or of small and medium-sized United States banks. In fact, as will be argued below, these divergences of interest between different groups of banks (and potentially between their respective governments) seem to constitute a significant threat to the continuation of the presently prevailing approach to debt rescheduling.

25. In this context, it should be noted, first of all, that the share of United States banks in international lending is not as high as it is sometimes made out to be, and that the position of non-United States banks cannot therefore be simply disregarded. The relative participation of United States banks in lending to non-OPEC developing countries declined from about 50 per cent of total bank claims in 1975-76 to 36 per cent in 1982; their share of total bank claims on Argentina, Brazil and Mexico declined in this same period from almost 660 per cent to 36 per cent. 17/

26. It should not be forgotten, moreover, that even within the United States banking community there exist sharp divergences of interest between money-centre and regional banks. As will be shown below, the latter account for a significant share of international bank claims and have generally opposed the crisis management procedures favoured by the larger United States banks. It seems therefore necessary to distinguish within the international banking community at least two different sources of resistance to the leading role played by major United States banks.

27. This section is divided into three subsections. It begins with a discussion of the specific situation and vulnerability of the major United States banks. The following subsections examine the differing position and approach of non-United States banks and of smaller United States banks.

#### The vulnerability of large banks in the United States

28. The vulnerability of major United States banks constitutes one of the central obstacles to a more lasting solution to the problems created by the international debt crisis. In fact, the essentially conservative approach typical of recent rescue operations must to a large extent be attributed to the specific difficulties faced by the large United States banks.

29. The extreme vulnerability of these banks to debt-servicing



disruption in Latin America and other regions is a relatively well-known fact. As can be seen from Table I.2, the claims of the nine largest United States banks on non-oil developing countries rose from \$US 30 billion in December 1977 to \$US 60.3 billion in June 1982, increasing at an average annual rate of 16.7 per cent in this period. Even more significant, however, is the fact that their exposure in these countries increased substantially as a proportion of their total assets and total capital. With total capital increasing at an average annual rate of 9 per cent in this period, the nine largest banks' relative exposure in these countries (defined as the ratio of claims to capital) rose from 163 per cent in December 1977 to as much as 223 per cent in June 1982 (Table I.2).

30. However, one should not lose sight of the fact that this level of relative exposure is a specific problem of the larger United States banks. Table I.3 shows that relative exposure to non-oil developing countries is directly correlated with bank size. Exposure as a percentage of total capital (or total assets) is significantly higher for the nine largest United States banks than for the next fifteen largest, and higher for the latter than for all other reporting banks. For the smaller banks, which held about 20 per cent of total United States bank claims on non-oil developing countries, total exposure made up less than three quarters of capital in June 1982.

31. It is sometimes argued that the concept of "relative exposure" as defined above tends to exaggerate bank vulnerability. According to this point of view, what should be stressed is the fact that claims on developing countries represent a relatively small fraction of total bank assets. The discrepancy between the ratio of claims on developing countries to total claims and the ratio of these claims to capital is of course simply a consequence of the banking system's high leverage: total bank assets are almost twenty times as large as total bank capital. Nevertheless, the ability to absorb losses and to resist unforeseen shocks depends essentially on the availability of capital and reserves. The ratio of claims to capital (including reserves) is therefore a much more reliable indicator of bank vulnerability to potential losses in lending to a specific country or groups of countries.

32. In reality, there are reasons to believe that the situation of the major United States banks is more not less problematic than the figures so far presented seem to suggest. In the first place, it should be observed that the figures reproduced in Tables I.2 and I.3 are based on a broad definition of capital, which includes equity and subordinated debt.<sup>18/</sup> In the second place, these figures do not include claims on OPEC and East European countries, several of which have suspended debt-servicing in one way or another in the recent past. If OPEC members and East European countries are included, these banks' total exposure rises to \$US 81.6 billion and 301 per cent of total capital in June 1982.<sup>19/</sup>

33. However, the most important aspect of these banks' vulnerability, not apparent in the aggregate ratios indicated in Table I.2, resides in

Table I.2 - Claims on Non-Oil Developing Countries:  
Country Exposure Lending Survey Data for the  
Nine Largest United States Banks, 1977-1982  
 (billions of dollars)

Date	Claims on non-oil developing countries (1)	Total assets (2)	Total capital (3)	(1)/(2) (Per cent)	(1)/(3) (Per cent)
1977 - December	30.0	372.5	18.4	8.1	163.0
1978 - June	31.0	390.2	19.0	7.9	163.2
December	33.4	422.5	20.0	7.9	167.0
1979 - June	35.0	449.8	21.1	7.8	165.9
December	39.9	486.1	21.9	8.2	182.2
1980 - June	41.9	508.4	23.0	8.2	182.2
December	47.9	531.0	24.0	9.0	199.6
1981 - June	51.6	553.7	25.0	9.3	206.4
December	57.6	564.6	26.1	10.2	220.7
1982 - June	60.3	566.3	27.1	10.6	222.5

Source: Paul A. Volcker, "How Serious is U.S. Bank Exposure?", in Challenge, May-June 1983, p. 15.

the concentration of their exposure in a relatively small number of major borrowers. As can be seen by comparing Tables I.2 and I.4, in recent years about half of the nine major banks' total claims on non-oil developing countries was accounted for by only three countries (Argentina, Brazil and Mexico). In June 1982, total claims on these three major borrowers made up as much as 113 per cent of these banks' total capital (Table I.3).

34. In the United States, disclosure standards applicable to banks go well beyond requirements imposed in other lending countries. <sup>20/</sup> For this reason, it is possible to specify the involvement of individual United States banks with major borrowing countries. Table I.5 shows the high relative exposure of some major United States banks vis-à-vis the four main Latin American borrowers. In the case of Manufacturers Hanover, for instance, loans outstanding to these four countries in December 1983 amounted to as much as 200 per cent of capital. Exposure to Brazil was equal to about two-thirds of capital in the case of Manufacturers Hanover and more than 70 per cent in the case of Citicorp.

Table I.3. Claims on Non-Oil Developing Countries  
Held by United States Banks, June 1982

Item	Total (billion dollars)	Share of total assets (per cent)	Share of total capital (per cent)
Claims on non-OPEC developing countries held by:			
All exporting banks	98.6	8.3	148.9
Nine largest banks	60.3	10.6	222.5
Next fifteen largest banks	19.0	7.9	149.6
All other reporting banks	19.3	5.0	73.1
Claims on Argentina, Brazil and Mexico held by:			
All reporting banks	52.4	4.4	83.6
Nine largest banks	30.5	5.4	112.5
Next fifteen largest banks	10.3	4.3	81.1
All other reporting banks	11.6	3.0	43.9

Source: Richard Dale and Richard P. Mattione, Managing Global Debt, The Brookings Institution, Washington, D.C., 1983, p. 14.

35. For the major United States banks, simultaneous debt-servicing crises affecting a large number of major borrowing countries in 1982-83 resulted therefore in the impairment of assets equivalent to a substantial proportion of capital. Table I.6 reports the value of the claims held by the nine largest United States banks on twenty major developing and East European borrowing countries. Thirteen of these twenty countries experienced debt-servicing disruption in 1982-83. In June 1983, claims held by the nine largest banks on these thirteen countries reached \$US 54.2 billion, amounting to as much as 63 per cent of their total claims on developing countries and East European countries. 21/ In June 1982, their claims on these same thirteen countries made up the equivalent of 193 per cent of their total capital.22/

36. For these large United States banks, the serious debt-servicing problems of major borrowing countries constitute therefore an undoubtedly significant threat. It should be noted that their vulnerability is partly a consequence of the absence of an adequate amount of reserves against losses. In 1982, the nine largest banks had an estimated total provision for losses of \$US 614 million, 23/ or only about 1.1 per cent of the total value of loans outstanding to 27 countries that have faced balance-of-payments crises in the recent past.24/

Table I.4. Claims on Argentina, Brazil and Mexico  
Held by the Nine Largest United States Banks,  
1977-1983

(billions of dollars)

Date	Argentina (1)	Brazil (2)	Mexico (3)	Total (4=1+2+3)
1977 - December	1.8	7.7	6.1	15.6
1978 - June	1.9	8.0	5.9	15.8
December	1.8	8.5	6.1	16.4
1979 - June	2.1	8.8	5.8	16.7
December	2.9	8.8	6.5	18.2
1980 - June	3.3	9.1	7.3	19.7
December	4.2	9.4	9.1	22.7
1981 - June	4.6	9.7	10.2	24.5
December	5.2	10.6	11.6	27.4
1982 - June	5.3	11.8	13.4	30.5
December	5.1	13.3	12.9	31.3
1983 - June	5.2	13.3	13.4	31.9

Sources: 1977 to June 1982: Paul A. Volcker, op. cit., p. 16;  
 December 1982 and June 1983: Federal Financial Institutions  
 Examination Council, "Statistical Release", mimeo., June 1983  
 and November 1983.

37. This extremely low level of reserves seems to reflect the fact that, in the United States, bank management and shareholders tend to attribute a particularly high value to reporting large quarterly profits and to sustaining high rates of dividend distribution in the short run. Moreover, in contrast to what happened in other industrialized countries in recent years, United States supervisory authorities do not seem to have been particularly concerned with stimulating loan provisioning. 25/

38. In reality, the large United States banks are no longer in a position to apply normal provisioning rates (initial provision of 10 per cent of face value, with additional annual provisions of 15 per cent, up to an eventual 50 per cent. 26/ As we have seen, loans outstanding to countries that have recently rescheduled or suspended debt-service payments were almost twice as large as the total capital of the nine largest banks in mid-1982. Setting aside reserves equivalent to 10 per cent of the face value of these assets would therefore absorb in a single year amounts equal to almost 20 per cent of total capital.



Table I.5. Claims on Argentina, Brazil, Mexico and Venezuela  
Held by Major United States Banks, 31 December 1983  
 (as per cent of capital)

Item	Argen- tina	Brazil	Mexico	Vene- zuela	Total	Capital (millions of dollars)
Citicorp	16.5	71.2	43.9	22.7	154.3	6,604
Bank of America	4.9*	40.6	44.8	26.4	116.7	6,117
Chase Manhattan	17.3	57.2	34.7	27.4	136.6	4,479
J. P. Morgan	18.3	44.1	29.0	11.5	102.9	4,047
Manufacturers Hanover	41.0	66.1	59.5	33.7	200.3	3,220
Chemical	13.1	45.2	50.1	27.5	135.9	2,821
Continental Illinois	16.7	19.8	29.1	18.2	83.8	2,398
Bankers Trust	10.2*	32.9	57.0	19.3	119.4	2,257

Source: Newsweek, 9 April 1984, p. 36; original data from Keefe, Bruyette and Woods, Inc.

\* Estimates.

39. Some of the basic features of recent rescue operations cannot be adequately explained without reference to this extreme vulnerability of major United States banks. The so-called forced lending system, described in section II of this study, is nothing but a financial device that enables these banks to artificially protect their balance sheets and income statements. Thanks to these forced or involuntary loans, which must actually be seen as an inefficient way of partially capitalizing interest payments, banks' balance sheets continue to carry doubtful assets at face value. Under current rescheduling procedures, banks can indefinitely defer write-offs or write-downs by maintaining that major debtor countries will eventually be capable of meeting their obligations. 27/ At the same time, bank income statements record as profits a flow of income which results directly from special loans advanced by the banks themselves. Citibank, for instance, is committed to lend Brazil \$US 443 million under a \$US 6.5 billion loan agreement signed in February 1983. This total, which will be fully returned to the bank in the form of interest, amounts to more than 25 per cent of parent Citicorp's gross profit for 1983. 28/

40. Because of the fundamental weakness of their basic position and of specific features of banking regulations in the United States, the major

Table I.6. Claims Held by the Nine Largest United States Banks  
on Developing Countries and East European Countries  
end-June 1983

Country	Debt (billions of dollars)	Debt-servicing disruption in 1982-1983
Mexico	13,422	yes
Brazil	13,280	yes
Venezuela	7,575	yes
Republic of Korea	6,307	no
Argentina	5,215	yes
Philippines	3,942	yes
Chile	3,065	yes
Indonesia	2,723	no
Colombia	2,263	no
Peru	1,463	yes
Yugoslavia	1,460	yes
Nigeria	1,456	yes
Malaysia	1,341	no
Thailand	1,212	no
Ecuador	1,119	yes
Algeria	806	no
Poland	776	yes
Morocco	727	yes
Uruguay	700	yes
Hungary	611	no

Sources: Federal Financial Institutions Examination Council, "Statistical Release", mimeo., November 1983; International Monetary Fund, Recent Multilateral Debt Restructurings with Official and Bank Creditors, Washington, D.C., December 1983, Occasional Paper No. 25.

United States banks constitute the strongest source of resistance to any substantial change in rescheduling arrangements. Capitalization of interest, which for reasons that will be discussed below constitutes a more rational approach to severe debt-servicing problems than the prevailing practice of financing interest payments through forced loans, is rejected because it would shatter the financial illusion on which present accounting criteria are based, and also because under current United States regulations interest capitalization would apparently force banks to classify the corresponding loans as non-performing assets. 29/ In fact, any attempt to make the rescheduling process more wide-ranging or more automatic tends to run up against the determined resistance of creditors that, being fully aware of their vulnerability to further debt-servicing disruption, will try to retain creditor leverage as long as possible.

41. Given their high level of exposure, these banks possess a natural inclination to present the balance-of-payments crises of countries like Argentina, Brazil and Mexico as "liquidity problems", i.e., as debt-servicing difficulties of an essentially temporary nature, that can be adequately managed under present arrangements without major concessions on the part of the creditors. But even if this basically optimistic view were to be considered unrealistic, the major banks would have other reasons, besides the ones already mentioned, to avoid establishing large reserves or writing down these loans. In fact, there is a risk that if countries become aware of widespread write-downs they may prove less willing to make the sacrifices necessary to meet debt payments. On the other hand, the tendency of smaller banks to reduce their level of involvement would probably be reinforced, leading to a further concentration of exposure in the major banks. 30/

#### The situation and outlook of non-United States banks

42. In contrast to the large United States banks, European and Japanese banks have followed a generally more cautious policy with respect to potential losses in international lending. Under direction from national regulatory authorities or on their own initiative, these institutions have been, by and large, more aggressive in writing off doubtful loans or establishing specific loss provisions. 31/ In Switzerland, for instance, the central bank has encouraged considerable provisioning for loans outstanding to countries like Brazil, Mexico or Poland. 32/ A similar tendency seems to have prevailed in other continental European countries.

43. In fact, major continental European banks have been led by a number of factors to make relatively larger risk provisions than banks from other parts of the world. An increase in gross profits and strong pressure from supervisory authorities, together with a generally favourable tax treatment of specific provisions, have allowed these institutions to prepare themselves more effectively for the recent adverse evolution of the international context. 33/ In contrast to their United States counterparts, these banks generally face less pressure from shareholders to pay large dividends. Despite higher

profits, some continental European banks have foregone increases in dividends to strengthen reserves and shelter profits against taxation.<sup>34/</sup>

44. Information obtained in direct contact with banks headquartered in the Federal Republic of Germany tends to confirm this general picture.<sup>35/</sup> In several crucial respects, their situation stands indeed in sharp contrast to that of the larger United States banks:

- (a) By and large, exposure to "problem countries", and specifically to countries in Latin America, seems to be significantly lower in absolute as well as in relative terms, partly as a result of a generally more cautious lending policy in recent years.
- (b) The tax treatment of reserves is more favourable than in the United States. For banks in the Federal Republic of Germany, provisioning against doubtful assets significantly reduces the tax burden.
- (c) Banks are not under strong pressure from shareholders to show high profits and pay large dividends on a quarterly basis.
- (d) Legislation in the Federal Republic of Germany (and in several other European countries) allows the use of hidden or inner reserves, i.e., of reserves that are not disclosed in balance sheet reports, a factor that tends to facilitate the accumulation of reserves. In the United States, by contrast, the maintenance of hidden reserves is not permitted. <sup>36/</sup>

45. These significant differences in the basic situation of larger United States banks and non-United States banks have led to important divergences in approaching the problem of international debt restructuring. In fact, it can be said without exaggeration that these divergences are sufficiently significant to weaken the co-operation between major central banks. This aspect of current negotiations has been well emphasized in a recent analysis of the international debt problem:

Banks can treat their international debt portfolios in two ways. One is to maintain the fiction that the portfolio is sound and show all income booked as earnings; the other is to build up bad debt reserves with all possible speed. We shall call one the high road, the other the low road. The high road is dangerous; it may necessitate a sudden, catastrophic adjustment. The low road uses the earnings capacity of the bank to accomplish a gradual adjustment. The major United States banks have no choice but to follow the high road. Any realistic reserve policy would impinge on their financial position too severely. (...) Many European banks, by contrast, have taken the low road. (...) The divergent reserve policies of the banks may eventually weaken the co-operation between central banks. When the survival of a country's commercial banks is no longer directly threatened, its central bank may become less flexible about committing resources to rescue packages. <sup>37/</sup>



46. Banks in the Federal Republic of Germany and in other European countries have, in fact, expressed strong dissatisfaction with the structure of recent rescue operations. Their criticism of the approach favoured by the major United States banks stresses the following basic points:

- (a) The system of forced lending is seen to involve excessively high transaction costs for both creditors and debtors. Given the large number of creditor banks and the diversity of their interests and situation, the setting up of "new money" arrangements for countries going through debt-servicing disruption leads to an enormous amount of attrition and time loss for the banks as well as for the economic authorities of the debtor countries.
- (b) The present system does not guarantee an equitable distribution of the burden of supplying new financing among the banks. This is due not only to the possibility that a significant number of banks may refuse to participate in additional loans, but also to differences in the currency composition of bank portfolios and in the interest rates for each currency of denomination. Under current procedures, European banks, whose dollar-denominated loans account for a smaller share of total loans outstanding, contribute proportionately more than United States banks to the financing of the overall interest burden, i.e., their contribution to "new money" facilities is larger than their share of interest payments.
- (c) It will become increasingly difficult to pressure smaller or less involved banks into contributing to further rounds of forced or involuntary lending. The growing tensions that will inevitably result from the attempt to force these banks into complying with the present system will tend to put interbank solidarity at risk. 38/
- (d) Given their improvised and short-term character, current rescue packages do not offer the prospect of a lasting solution and cannot therefore significantly contribute to the re-establishment of stability and confidence.

47. In contrast to the short-term approach that seems to prevail in the United States, European banks tend to take a longer view and to believe that a normalization of financial relations with most countries now experiencing debt crises will not occur before the end of this decade. According to this point of view, banks would be advised to recognize the urgent need for unconventional solutions and for an extension of the time horizon contemplated by debt restructuring arrangements.

48. While the major United States banks tend to see the punctual payment of interest as indispensable, Europeans have come out in favour of the capitalization or deferment of interest payments as an alternative to forced lending. 39/ The resistance of United States

banks to this sort of proposal is partly based on the view that United States banking regulations would force them to classify all affected loans as non-performing assets.

49. It should be noted, however, that United States supervisory authorities have accepted in at least two recent cases solutions that involved a temporary postponement or capitalization of interest payments without requiring the classification of the corresponding loans as non-performing. In the case of Mexico, interest due on the private sector's foreign debt was paid in local currency into a blocked account at the Mexican central bank; the corresponding loans were nevertheless considered as current for bank regulatory purposes. <sup>40/</sup> Nicaragua reached in 1980 an agreement with its creditors whereby a maximum interest rate of 7 per cent is paid and the difference between the prevailing rate and the 7 per cent ceiling automatically capitalized.<sup>41/</sup> In any case, only United States and Canadian banks are affected by regulations that would tend to obstruct a capitalization or rescheduling of interest payments. In other industrialized countries, assets are written-down and provisions established not as the result of automatic rules, but on the basis of decisions that reflect the recommendations made by supervisory authorities or the bank's own initiative.

50. European banks can therefore be expected to continue to argue in favour of substantial changes in the structure of rescue operations. In fact, even when viewed exclusively from the point of view of the banks, capitalization of interest has a number of advantages over current procedures:

- (a) Because of its intrinsically automatic nature, capitalization of interest would lead to the immediate elimination of the high transaction costs involved in the setting up of forced or involuntary loans.
- (b) In contrast to forced lending, capitalization constitutes a continuous method of financing, involving therefore less public exposure and "press-visibility" than the current practice of piecing together, after prolonged and difficult negotiations, large "new money" packages on an annual basis.
- (c) Shareholders and bank management would accept interest capitalization, imposed on each individual bank in the context of an overall scheme, more readily than further requests to assume the responsibility of participating in new loans.
- (d) In contrast to the present system, capitalization automatically guarantees a balanced distribution of the burden of covering the debtor's net financial requirements, each bank contributing in proportion to its effective share of total interest due.

51. Capitalization or rescheduling of interest payments can of course be implemented in different ways and with varying degrees of coverage of

payments due. It can involve, for instance, the creation of blocked accounts, paying LIBOR plus a certain spread, into which all or a part of the interest due would be automatically paid. Alternatively, cash payment of interest could be partially or fully replaced by the creation of negotiable bonds carrying flexible or fixed rates. In so far as the coverage of capitalization is concerned, one of the ideas put forth would establish a maximum interest rate, defined as a fixed "equilibrium" real rate plus the observed rate of interest, and automatically capitalize any difference between this maximum rate and the market rate of interest.

52. It should be observed, however, that interest capitalization is not necessarily seen by European banks as a way of increasing credit supply and of changing the relationship between adjustment and financing to the benefit of debtor countries. The view of the major banks in the Federal Republic of Germany, for instance, seems to coincide with that of their United States counterparts in the assumption that debtor countries will be able and willing to cover with real resources a substantial share of debt service over the next few years.

53. In any case, there does seem to exist a fundamental difference between the European and United States approach to the debt crisis. The European preference for interest capitalization seems to reflect the perception that the debt crisis does not constitute a merely temporary disturbance. For the same reason, many European banks have for some time favoured a lengthening of consolidation periods, i.e., the replacement of short-term reschedulings by three-year or five-year restructuring schemes. <sup>42/</sup> By contrast, until very recently the major United States banks seemed to display a clear preference for the so-called short-leash approach. For their part, European banks seem to believe that the loss of creditor leverage resulting from capitalization of interest and longer consolidation periods would be more than compensated by the favourable effects of restructuring schemes that could be perceived as lasting arrangements, capable of offering debtor countries a longer planning horizon. Although European banks can be expected to go out of their way in attempting to preserve interbank solidarity, United States intransigence and the specificity of the problems faced by major United States banks may yet lead them to negotiate separate rescheduling arrangements or at least to press for the introduction of an optional clause allowing for interest capitalization as an alternative to participation in new loans.

#### Small and medium-sized banks

54. Smaller banks tend to be even more radical in their rejection of the current approach to the debt crisis. In the United States as well as in Europe, small and medium-sized banks have frequently been openly critical of the way the issue has been handled by the major banks and have constituted one of the chief sources of resistance to the implementation of recent rescue operations.



55. These differences of attitude and behaviour are of course essentially a reflection of substantial differences in the degree of relative exposure. As we have seen, relative exposure is generally much lower in the case of medium-sized United States banks and even lower in the case of small United States banks (Table I.3). Loans made by United States regional banks to Brazil, for instance, rarely amount to more than 20 per cent of their capital base. 43/

56. In fact, there is a significant risk that smaller banks will increasingly refuse to participate in the system of forced lending; and the difficulty of ensuring their co-operation is a potentially serious source of weakness in future rescue operations. The nine largest United States banks account for about 60 per cent of total United States bank exposure in Argentina, Brazil and Mexico. The remaining 40 per cent are divided equally among the next fifteen largest and all other reporting banks. 44/ If an increasing number of these small and medium-sized institutions stay away from future "new money" arrangements, the capacity of the larger banks to compensate for their withdrawal is clearly open to question. Even if they were capable of doing it, the inevitable consequence would be an exacerbation of the already excessively high concentration of exposure among a relatively small group of large banks. 45/ Alternatively, the withdrawal of smaller banks could lead the major banks to drastically reduce the amount of "new money" in future rescue operations. Given the limited availability of non-bank sources of capital, this would however inevitably force debtor countries to generate even higher outward transfers of real resources.

57. Notwithstanding the intense dissatisfaction of smaller banks, it has been argued that involuntary lending is a "relatively robust mechanism", one of the alleged reasons of this robustness being the fact that "smaller banks are well aware that their non-participation would amount to benefiting at the expense of larger banks". 46/ This argument neglects, however, the fact that degrees of relative exposure are substantially higher for the large banks and that for this reason the successful conclusion of "new money" deals is of a much more crucial importance to them than to smaller banks that have low exposures relative to capital. The latter are of course in a much better position to write-down dubious assets and to establish adequate levels of loan loss reserves.

58. Among smaller banks, the extension of new loans to insolvent debtors is predominantly viewed as a useless and costly exercise in self-delusion. The lack of confidence in present procedures seems to be extremely widespread. The current approach is seen as unrealistic and essentially incompatible with the interests of a large majority of banks. In these circles, majority opinion favours the replacement of forced lending schemes by a policy of systematically writing-down a large share of loans outstanding to developing and East European countries.

59. This sort of assessment is based of course on a generally



pessimistic evaluation of the repayment prospects of problem countries in Latin America and other regions of the world. There is a clear tendency to consider a part of these debts as essentially irrecoverable and to accept therefore radical proposals that could involve, for instance, the restructuring of debt service over long periods at less than market rates.

#### IV. The International Debt Crisis from the Viewpoint of Borrowing Countries

60. The previous section discussed the situation of different groups of creditor banks and their attitudes towards the current approach to the international debt crisis, with special attention given to the vulnerability of the large United States banks, which have played a major role in the organization of financial rescue packages, and the different situation and views of European and regional United States banks. The main purpose of the analysis contained in section III was to stress the existence of important interbank strains, that constitute a potentially significant threat to the survival of rescue operations in their present shape.

61. However, the viability of the current approach to crisis management also depends upon its effectiveness in meeting the needs of debtor countries experiencing severe balance-of-payments problems. As already pointed out in section II of this study, there are several reasons for the debtor countries to consider so-called rescue packages as inappropriate and contrary to their basic interests. In fact, the amount and cost of the external financing provided in these recent operations must be seen as clearly inadequate. As will be argued below, under currently prevailing conditions emergency financial assistance is provided in such a way as to force debtor countries to take on the major share of the costs involved in managing the international debt crisis.

62. The recent evolution of most developing and East European countries is characterized by a widespread deterioration of their overall economic situation. In 1982-83, a large number of these countries experienced significant reductions in per capita income, sharp increases in the rates of unemployment and underemployment, and accelerating inflation. The situation of Latin American economies is particularly critical; the region's per capita income declined by about 13 per cent during 1981-83 and average inflation moved up from 53 per cent in 1980 to 133 per cent in 1983. 47/

63. This deterioration of internal macroeconomic indicators is closely related to a pronounced deterioration of the external sector of these economies. During this period, few developing and East European countries managed to escape from substantial balance-of-payments deficits and corresponding reductions in the level of international reserves. These external deficits, resulting to a large extent from a drastic reduction in net capital inflows, were almost immediately reflected in a dramatic increase in the number of countries unable to

continue normal debt-servicing. According to World Bank data, in 1983 27 countries formally rescheduled debt payments amounting to almost \$US 70 billion. 48/ In 1982-83, no less than 34 countries suspended debt-servicing or formally rescheduled their foreign debts. In Latin America, the list of rescheduling countries comprises all of the region's major economies except Colombia. 49/

Net financial transfers from debtor countries to the banks

64. The substantial worsening of the overall economic situation of a large number of developing and East European countries is to a large extent due to the sharp and unexpected reduction of international bank credit since 1982 and to the inadequacy of rescue operations set up in response to it. 50/ The sudden change in the way banks perceived the risks involved in lending to Latin America, Eastern Europe and other regions resulted, in fact, in a sharp reduction in the growth of international credit. During the 1970s, commercial banks had become the main source of external financial resources for a large and increasing number of countries. The marked reduction in the supply of bank loans since mid-1982 could not therefore have failed to produce serious repercussions in all or almost all regions of the world.

65. According to data collected by the Bank for International Settlements, from end-June 1982 to end-1983 gross bank lending to countries outside the BIS reporting area reached \$US 41.3 billion, as against \$US 92.1 billion in the previous eighteen months 51/ Given the extremely high level of international interest rates throughout this period, this drastic reduction in the volume of lending resulted, in fact, in a substantial net transfer of resources from the debtor countries to the banking system of the industrialized countries. The paradoxical and premature character of these transfers has been brought forth forcefully in a recent statement of the President of the World Bank:

New commercial-bank lending to developing countries, especially to major borrowers, has fallen dramatically. As a result, the net transfer from commercial banks to developing countries (that is, new lending minus debt-service payments) is now negative. The developing countries are repaying more to the banks than the banks are lending.

According to the World Bank's Debtor Reporting System, the net transfer of medium and long-term lending from private sources to developing countries was \$16 billion in 1981. But in 1982, the net transfer was a negative \$7 billion. We estimate a negative net transfer of \$21 billion for 1983.

Productive investment yields a return, and foreign investors should get back more than they invest. But it is premature for developing countries, as a group, to be transferring resources to the high-income countries on this scale. In 1983, the net transfer from the 13 major borrowers among the developing countries to private lenders was equivalent to 2 per cent of their national income. 52/

66. This sharp reversal of the flow of resources between the banks and the developing countries was not offset by other sources of external capital. The figures for net direct investment show, on the contrary, a significant decline, from a total flow of \$US 14 billion in 1981, down to \$US 13 billion in 1982 and \$US 10 billion in 1983. In addition, the net transfer resulting from medium and long-term lending by official sources to developing countries remained approximately constant between 1981 and 1983. 53/

67. The sharp reduction of bank credits, combined with declining direct foreign investments and the stagnation of net transfers from official credit sources, resulted in violent pressure on the external accounts of most developing countries, whose external situation was already significantly damaged by the adverse evolution of the international context since 1979-80 and by the often inadequate response of domestic economic policies. After having sharply reduced or even exhausted their foreign exchange reserves and every possibility of access to short-term credit, a considerable number of these countries were forced to drastically cut back imports.

68. The sudden decline in the capacity to import occurred with particular intensity in Latin America in this period. Between 1981 and 1983, a reduction of about 40 per cent in total merchandise imports, which was more than sufficient to compensate for the fall in exports and for the increase in net payments of interest and profits, led to a drastic reduction of the balance-of-payments deficit on current account. This sharp change in the current account was largely due to a dramatic decline in net capital inflows in 1982 and 1983 (Table I.7).

69. Such a pronounced reduction in capital inflows, reflecting the strong involvement of the countries of the region with international banks and their resulting vulnerability to fluctuations in the supply of bank credit, led to a drastic reversal of net financial transfers in 1982-83 (Table I.8). In 1982, net payments of interest and profits exceeded net capital inflows by \$US 20.2 billion, but this difference could still be covered by using international reserves. In the following year, however, in the face of a virtual exhaustion of the reserves of most countries, the net outward transfer, estimated at \$US 29.5 billion, had to be financed almost exclusively by net exports of goods and non-factor services. In fact, preliminary data indicate that, in 1983, 75 per cent of Latin America's net payments of interests and profits were financed by surrendering real resources, 12 per cent by the use of reserves and only 13 per cent with capital inflows (Tables I.7 and I.8). This massive outward transfer of resources, generated to a large extent by a dramatic reduction of imports, is one of the basic causes of the recent substantial decline in per capita income and the sharp increase in rates of inflation to which reference was made at the beginning of this section.

Table I.7. Latin America: Main Items of  
the Balance-of-Payments, 1977-1983

(billions of dollars)

Item	1977	1978	1979	1980	1981	1982	1983 <sup>a/</sup>
Exports of goods	48.2	51.8	69.6	90.5	96.8	88.6	87.5
Imports of goods	48.3	55.0	69.1	91.5	98.4	78.9	56.3
Trade balance	-0.1	-3.2	0.5	-1.0	-1.6	9.7	31.2
Net payments of interest and profits	8.6	10.5	14.2	19.0	29.0	36.8	34.0
Balance on current account <sup>b/</sup>	-11.7	-18.3	-19.6	-27.7	-40.4	-36.4	-8.5
Net capital movements <sup>c/</sup>	17.3	26.4	29.0	29.9	38.0	16.6	4.5
Global balance	5.6	8.1	9.4	2.2	-2.3	-19.8	-4.0

Source: Comissão Econômica para América Latina, "Balanco preliminar da economia latino-americana durante 1983", mimeo., dez/83, Quadro 1.

<sup>a/</sup> Preliminary estimates.

<sup>b/</sup> Includes net unrequited private transfer payments.

<sup>c/</sup> Includes long and short-term capital, unrequited official transfer payments, and errors and omissions.

#### Macroeconomic implications of the outward transfer of resources

70. An adequate understanding of the implications of the process whereby developing countries transfer resources to the banking system of the industrialized countries involves shifting the emphasis from the concept of current account deficit to the analytically more relevant concept of resource gap. The latter is defined as the difference between imports and exports of goods and non-factor services, which is basically equivalent to the difference between the total deficit on current account and the components of the current account that are directly related to capital movements (interest, profits and dividends, etc.). Reference to the deficit on current account should be avoided, in this context, for two different reasons. Firstly, because in a



**Table I.8. Latin America: Capital Inflows and Net  
Financial Transfer, 1973-1983**

(billions of dollars)

Year	Net capital movements (1) <sup>a/</sup>	Net payments of interest and profits (2)	Net transfer (3) = (1) - (2)
1973	8.1	4.4	3.7
1974	11.6	5.3	6.3
1975	14.5	5.8	8.7
1976	18.3	7.0	11.3
1977	17.3	8.6	8.7
1978	26.4	10.5	15.9
1979	29.0	14.2	14.8
1980	29.9	19.0	10.9
1981	38.0	29.1	8.9
1982	16.6	36.8	-20.2
1983 <sup>b/</sup>	4.5	34.0	-29.5

**Source:** Comissão Econômica para América Latina, "Balanco preliminar da economia latino-americana durante 1983", mimeo., dez./83, Quadro 13.

<sup>a/</sup> Includes unrecorded transactions.

<sup>b/</sup> Preliminary figures.

situation of widespread inflation and floating interest rates in international financial markets, the nominal value of interest payments registered in the balance of payments on current account includes a compensation to the lender for the erosion in the future value of the debt. The current account of the balance of payments is, therefore, distorted by the fact that inflation- induced interest rates have the effect of transferring repayments of principal from the capital account to the current account. <sup>54/</sup> Secondly, because the existence of a current account deficit does not necessarily imply net absorption of external resources and may even be associated with a substantial outward transfer of resources in the form of an excess of domestic output over aggregate expenditure.

71. This second point deserves closer consideration. As is well known, in an open economy, the identity between aggregate output and absorption, valid for a closed economy, is transformed into an identity between output and domestic absorption plus net exports:

$$Y = C + I + X - M \quad (1)$$

where:  $Y$  = gross domestic product;  
 $C$  = consumption;

I = fixed investment plus inventory accumulation;  
 X = exports of goods and non-factor services; and  
 M = imports of goods and non-factor services.

72. From the point of view of macroeconomic aggregates, the resource gap, as defined above, corresponds therefore to an excess of domestic demand over GDP:

$$M - X = (C + I) - Y \quad (2)$$

73. The absorption of external resources, expressed in a positive resource gap, allows domestic expenditure to exceed domestic output. Given that the balance on current account basically reflects the resource gap and net payment of interest and profits, the existence of a current account deficit will cease to be associated with an absorption of external resources whenever net factor payments equal or exceed the total current account deficit. <sup>55/</sup> Even with international price stability, the balance on current account constitutes therefore a misleading measure of the absorption of external resources.

74. An understanding of the macroeconomic implications of the reversal in the flow of resources resulting from the sharp reduction in international bank credit presupposes, therefore, the use of a concept which directly expresses the relationship between aggregate expenditure and domestic output. It should be pointed out, however, that the resource gap differs from the concept of net financial transfer used in Table I.8. In fact, the balance-of-payments identity establishes that the change in net reserves is equal to the sum of the balance of current account and net capital movements: <sup>56/</sup>

$$X - M - J - L + E - A + ID = R \quad (3)$$

wherein: J = net payments of interest;  
 L = net payments of profits and dividends;  
 E = net inflow of autonomous loans;  
 A = net amortizations;  
 ID = net inflow of direct investment; and  
 R = net international reserves.

75. By rearranging terms, we obtain an identity that relates the resource gap to the net financial transfer, as defined in Table I.8, and to the change in reserves:

$$M - X = [(E + ID) - (J + A + L)] - \Delta R \quad (4)$$

76. Thus, when the net financial transfer becomes negative, i.e., when net factor payments exceed net capital inflows, the internal macroeconomic impact of this reversal can be minimized or even neutralized by the reduction in the level of net reserves. As previously stated, the reduction of reserves did, in fact, perform this compensatory function during the first phase of the debt crisis.

However, after a relatively rapid exhaustion of reserves, net financial transfers began to be covered by a substantial outward transfer of real resources, i.e., by a negative resource gap.

77. When debtor countries are required to respond to the reduction in the supply of bank loans by generating a significant surplus in their commercial and non-factor services accounts, this necessarily involves allocating a share of domestic output to debt-servicing. It can be demonstrated that the share of domestic output absorbed by the outward transfer of real resources depends essentially on three factors: a) the average interest rate; b) the growth rate of the external debt; and c) the debt/output ratio. The growth of a country's net external debt defined as the difference between gross debt and reserves, depends essentially on the resource gap, the average interest rate and the net contribution of direct foreign capital: 57/

$$\frac{\Delta DL}{DL} = \frac{M - X}{DL} + i + \frac{ID - L}{DL} \quad (5)$$

where: DL = net external debt; and  
i = average interest rate.

78. Assuming  $ID - L$  to be approximately equal to zero and rearranging terms, we arrive at an expression that relates the resource gap (with inverted sign) to the difference between the average interest rate and the debt growth rate:

$$\frac{X - M}{DL} = i - \frac{\Delta DL}{DL} \quad (6)$$

79. Multiplying both sides of the equation by the debt/output ratio and substituting (2) into (6), we arrive at the expression that links the share of output transferred abroad to the three above-mentioned factors:

$$\frac{Y - (C + I)}{Y} = (i - \frac{\Delta DL}{DL}) \cdot \frac{DL}{Y} \quad (7)$$

80. This equation conveniently summarizes some of the central elements of the present situation. Given the importance of commercial banks as a source of capital for Latin American countries, the sharp reduction of bank credit -- and the practical impossibility of compensating for this reduction through an increase in loans from governmental or multilateral sources -- automatically resulted in a drastic reduction in the rate of growth of the region's foreign debt. At the same time, average interest rates have remained and will probably continue to remain at extremely high levels. Consequently, average interest rates have substantially exceeded debt growth, by as much as 6 or 7 percentage points during the first phase of the crisis.

81. The high average interest rates paid by Latin American countries reflect, as is generally known, three basic factors:

- (a) persistently high real basic rates in international financial markets, primarily as a result of the combination in the United States of a generally restrictive monetary policy with structural fiscal deficits; 58/
- (b) a significant and generalized increase of spreads and commissions charged by banks in recent rescue operations; 59/
- (c) the composition of Latin American external debt, chiefly made up of loans extended by commercial banks at floating interest rates. 60/

82. Unless interest rates fall substantially, the planned reduction in the growth rate of bank exposure in Latin America will probably lead to an increasingly large difference between the rate of interest and the rate of growth of overall debt. Since the foreign debt corresponds to a significant share of total output and exports of these countries, the inevitable result will be outward transfers amounting to a substantial and increasing share of GDP and exports.

83. Starting from equation (7) and from preliminary estimates for 1983, 61/ Table I.9 attempts to quantify, on the basis of present trends, the share of Latin America's output and exports that will be absorbed by outward transfers over the next few years. This type of exercise, although always based on assumptions which are to some extent arbitrary, may shed some light on the potential dimension of the real resource transfer resulting from the sharp reversal of financial flows. The assumptions mentioned in Table I.9, which appear to be compatible with present trends and with the spirit and characteristics of financial rescue operations as described in section II of this study, lead to the conclusion that Latin America will be compelled to dedicate a high and increasing share of both its GDP and exports to the servicing of external debt. 62/ If the assumptions on which this exercise is based are broadly correct, the outward transfer of resources will absorb as much as 5 per cent of the region's total output and 30 per cent of its total exports during the period 1986-88.

84. The domestic costs associated with an outward transfer of this magnitude will of course depend on the rate at which world trade expands and on the evolution of the region's terms of trade. In the absence of a recovery of external demand and of the terms of trade, the outward transfer resulting from the increasing gap between interest rates and the rate of growth of bank debt will probably take place at the cost of a reduction or stagnation of economic activity and/or of an intensification of inflationary pressures in Latin America.

85. Although a discussion of the general outlook for the world economy lies outside the scope of this study, mention must be made of the fact that there is more than one reason to question the sustainability of the economic recovery initiated by the United States in 1983. The existence of a substantial fiscal deficit in the United States and the prospect of continuous growth in the deficit's structural component constitute,



Table I.9. Latin America: Projected Transfer of Real Resources as a Proportion of GDP and Exports, 1983-1988

(per cent)

Item	1983	1984	1985	1986	1987	1988
Average interest rate	13.0	13.0	13.0	13.0	13.0	13.0
Rate of growth of net foreign debt <u>a/</u>	7.0	5.0	3.0	1.0	0.0	0.0
Foreign debt/exports <u>b/</u>	269.0	266.6	259.2	247.2	231.1	214.0
Foreign debt/GDP <u>c/</u>	41.4	41.8	41.4	40.2	38.4	36.2
Transfer of real resources/exports	16.1	21.3	25.9	29.7	30.0	27.8
Transfer of real resources/GDP	2.5	3.3	4.1	4.8	5.0	4.7

a/ Given that the level of international reserves must be substantially increased over this period, it is assumed that the rate of growth of net debt will be significantly lower than the rate of growth of gross debt and of the gross exposure of banks to countries in Latin America.

b/ Foreign debt at the beginning of the year over exports of goods and services. Exports are assumed to grow at a constant annual rate of 8 per cent in this period.

c/ Foreign debt at the beginning of the year over gross domestic product. Nominal GDP is assumed to grow at a constant annual rate of 6 per cent in this period.

through their direct and indirect effects on interest rates in the United States and in the rest of the world, a clear threat to the continuation of economic recovery over the medium-term. 63/ It should be noted, in addition, that the reduction in United States inflation rates in recent years was partly due to falling commodity prices and to the substantial appreciation of the dollar vis-à-vis other currencies. 64/ The clearly temporary or reversible nature of an apparently significant share of the gains recently obtained by anti-inflationary policy in the United States represents an additional threat to the continuation of expansion over the coming years. In so far as

Western Europe is concerned, the existence of serious structural problems seems to make a rapid and sustained recovery unlikely in the medium-term. 65/ Furthermore, the proliferation of protectionist practices has hampered and will probably continue to restrain the growth of world trade and, in particular, of exports from debtor countries. 66/ Given the significance of developing economies as markets for exports from the industrialized countries, the stagnation or slow growth of economic activity and the serious balance-of-payments problems of those countries will also tend to obstruct the recovery now in progress in the United States and in other OECD countries. 67/

86. In any case, it is difficult to imagine that a process that forces low per capita income countries to transfer to higher income countries a substantial share of their output and exports, could be considered an acceptable way of solving the international debt crisis. The paradox of the present situation becomes even more evident when one considers that the United States, the largest economy and one of the richest countries in the world, is the chief beneficiary of these transfers. As a result of a substantial increase of the fiscal deficit and of the low savings rate of the private sector in the United States, a sizeable share of the borrowing requirements of the United States Government is being financed through the absorption of external resources on a large scale. 68/

87. Under normal conditions, resources should of course flow from the more developed economies, in which capital is relatively abundant, towards less developed economies, which are characterized by relative capital scarcity. In fact, there is no reason to admit the need for a reversal of these net transfers of resources in the foreseeable future. On the contrary, flows of resources to developing countries should persist as long as there are significant differences in international capital endowments. 69/

88. An even more problematic assumption, apparently current in some banking circles, is that this paradoxical reversal of the flow of resources does not merely constitute a passing phenomenon, but a lasting trend which will prevail at least for the rest of the present decade. As stated in the second section of this study, current rescue operations were conceived in such a way as to allow for an organized reduction of the extremely high relative exposure of major international banks. Under present conditions, this objective can only be attained by reversing net financial flows between the banking system and the debtor countries for an extended period of time. Thus, it is not at all surprising that Chase Econometrics Associates Inc., for instance, should calculate that the sixteen major debtor countries will have to repay approximately \$US 130 billion more than what they will receive in the form of new capital over the next five years. 70/

89. However, one of the weak points of the approach favoured by the major United States banks is precisely the assumption that debtor countries will passively allow this situation to continue indefinitely. This is an aspect which is fully recognized in some of the more realistic assessments of current international financial problems:

Debtor countries may be willing to repay more than they are receiving for a limited period of time, especially if the prospect that credit markets will open up again is clearly visible, but it is unrealistic to expect them to tolerate negative resource transfers for an extended period of time. 71/

90. Indeed, it is difficult to imagine that debtor countries will be willing to continue to abide by the rules of the game and to remain linked to a financial system that proves incapable of providing an adequate volume of financing on acceptable terms.

#### V. Elements of an Extended Restructuring of International Debts

91. The main purpose of the previous sections was to supply evidence, from a number of different points of view, demonstrating the inadequacy of recent rescheduling and financing schemes. It has been argued that the prevailing form of crisis management, besides having substantial negative effects on the debtor countries, encounters strong resistance from banks outside the United States as well as from small and medium-sized United States banks. It is, therefore, only too evident that there is a need to search for alternatives that could offer a prospect of a real solution to the pressing problems generated by the international debt crisis.

92. The working out of a universal solution which could be indifferently applied to the several dozens of debtor countries experiencing debt-servicing crises is of course hampered by the extreme diversity of the problems faced by each individual country. Nevertheless, it would appear to be perfectly possible to outline some general principles which could help in establishing a more realistic approach to the serious balance-of-payments difficulties of these countries.

93. It must be recognized, first of all, that the problems posed by the international debt crisis are of a long-term nature and can therefore only be adequately solved in the course of an extended period of time. The depth of the imbalances and distortions accumulated in recent years requires, as a matter of fact, wide-ranging operations aimed at consolidating and restructuring international debts in such a way as to provide the debtor countries with the time and breathing space needed to reorganize their economies and to create the conditions for a gradual normalization of their external financial relationships.

94. From the point of view of debtor countries, revision of current rescheduling schemes must involve three basic changes in current practice:

(a) capitalization of interest;

(b) substantial reduction of spreads; and

(c) extension of loan maturities and of debt consolidation periods.<sup>72/</sup>

95. Adoption of a rescheduling programme based on these central points would make possible a simultaneous recovery in the level of imports and of reserves, and would allow, under certain conditions, a substantial improvement in basic debt indicators. As we will argue below, a programme of this kind would not only eliminate the more perverse features of present "rescue" operations, but would also offer a real opportunity for achieving solutions for the debt crisis over the medium and long term.

#### Interest capitalization as an alternative to the system of forced lending

96. As a way of financing the net credit requirements of countries going through severe debt-servicing problems, interest capitalization has a number of advantages over current procedures. Capitalization or rescheduling of interest is the process by which payments of interest due in a certain period are automatically transformed into new loans. It involves, therefore, the substitution of actual cash by accrual payments, i.e., by accounting operations entirely analogous to those which are already being carried out for amortization payments.

97. In fact, the system of forced lending is simply an indirect and inefficient manner of capitalizing or rescheduling (a part of) the interest payments due to the banks. Section III discussed the reasons why banks in the Federal Republic of Germany and other European countries usually reject the system of forced lending and favour its replacement by a scheme of partial capitalization of interest. From the debtor countries' point of view, interest capitalization also has several advantages when compared to the current practice of (partial) financing of interest by means of new loans:

(a) Being an automatic procedure, capitalization avoids the high transaction costs associated with the forced lending system. The laborious and prolonged negotiations which preceded the conclusion of the jumbo-loan of \$US 6.5 billion, recently obtained by Brazil, and the difficulty in guaranteeing the participation of hundreds of individual creditor banks from all over the world, have demonstrated how high the cost of the present system can be for the economic authorities of the debtor country in terms of time consumed.

(b) Through capitalization it becomes possible to accommodate automatically unforeseen increases of international interest rates. Under the current scheme, any unexpected increase of basic interest rates (generally LIBOR or prime rate) results in an automatic reduction of the share of interest covered by new money. Given the instability and unpredictability of interest rates and the large share of debts contracted at floating rates



or for periods of less than one year, the ratio of new loans to interest payments is subject to marked fluctuations which may significantly hamper the administration of external accounts in the short term.

- (c) Insofar as it eliminates the need to offer attractive financial conditions to insure the participation of creditor banks in new medium-term loans, capitalization of interest would tend to facilitate the reduction of spreads and the lengthening of grace and amortization periods. Under the current approach, the attempt to distribute among the greatest possible number of banks the burden of financing the net credit requirements of "problem countries" limits the possibility of obtaining a reduction in spreads and an extension of maturities.
- (d) By making possible the compulsory financing of a substantially larger proportion of interest payments, a capitalization scheme could avoid (or at least limit) the outward transfer of resources. By its very nature, depending as it does upon the decisions of several hundred individual banks, the forced lending system does not permit an increase in the level of financing. On the contrary, the chances of success of the present system seem to be based on the assumption that it will be possible to guarantee a relatively rapid reduction in the rate of growth of bank exposure in "problem countries" over the next few years. Given the size of existing debts, the high average interest rate and the inelasticity of the supply of capital from non-bank sources, the current approach implies in fact a massive outward transfer of real resources from the debtor countries. Under present conditions, these transfers can only be avoided or controlled by the compulsory increase of the level of financing which could result from the introduction of an interest capitalization system.

98. It is a well-known fact that interest capitalization can be implemented in several different ways. In the recent past, in the light of the increasingly discernible inadequacy of the current approach and of rising interest rates in the United States, the alternative of a partial capitalization of interest has been gaining growing support in banking and governmental circles. One of the proposals for partial capitalization under discussion would fix a maximum interest rate, say 7 per cent, which would continue to be paid by the debtor country, and add to the stock of debt the difference between this rate and the market rate of interest. The maximum rate of interest would result from the addition of a real "historical" interest rate in international financial markets, calculated on the basis of the average value observed in the last 20 or 30 years, to the current inflation rate.

99. This sort of proposal is, in more ways than one, clearly preferable to the current approach. In fact, besides facilitating an improvement in the financial conditions of credits supplied, it would avoid the high transaction costs which are inherent in the implementation of the forced

lending system and automatically accommodate unforeseen increases of international interest rates. In addition, it would also interrupt the trend towards reduction in the ratio of new loans to interest payments which is apparently implicit in the current form of crisis management.

100. However, a merely partial capitalization of interest would not be sufficient to avoid a substantial transfer of resources from debtor countries to the banking system. In the afore-mentioned example, if interest rates stay at present levels, in the range of 14 or 15 per cent, and given the absence of significant reserves and the inelasticity of non-bank resources of capital, debtors would have to transfer to the banking system real resources equivalent to about 7 or 8 per cent of the stock of their foreign debt. Considering that these countries face the urgent need to increase substantially their imports and their international reserves, and that they must do this in an international context which still is basically unfavourable and full of uncertainties, an adequate solution to the present problems of many countries seems to require, in fact, the full capitalization of interest on medium and long-term bank loans. Since medium and long-term bank debt accounts for a very high share of total debt, and since its average cost is significantly higher than that of other liabilities, such a proposal would lead to the capitalization of almost all interest payments due 73/ and would represent, therefore, a radical change in the approach to the problem.

101. As has been previously mentioned, the major United States banks constitute the main source of resistance to any change in present debt renegotiation schemes and seem to reject even moderate proposals, such as partial interest capitalization. This resistance is based, ostensibly at least, on the specific characteristics of United States banking regulations, 74/ a supposedly crucial obstacle to any proposal involving capitalization, even if only partial, of interest. But can this argument be taken seriously when one considers the incoherence of regulations that generally classify as "non-performing assets" loans on which interest has been capitalized, and yet allows them to be recorded as "performing" when interest is paid with resources originating from the creditor banks themselves through operations which are rigorously equivalent to an indirect and inefficient capitalization of interest payments?

102. In fact, there seem to be stronger reasons behind this resistance. The automatic nature of capitalization would tend to reduce creditor leverage and undermine the attempt to keep unreliable debtors on a "short-leash" and under permanent pressure to adjust. 75/ In addition given the high exposure of the major United States banks in the countries concerned, there may be a fear that adoption of "unconventional" solutions could lead to funding difficulties or to an even more drastic reduction in the prices of these banks' equity shares.

103. But from the debtor countries' point of view, and even from that of a large part of the international banking community, such arguments do not carry much weight. There are indications that even United States

monetary authorities would presently be inclined to favour some kind of partial interest capitalization. 76/

#### Rescheduling terms

104. It must be stressed, however, that a realistic approach to debt restructuring requires not only a fundamental change in the relationship between adjustment and financing, but also a substantial revision of rescheduling terms. Given the extremely high level of international interest rates and of spreads charged in recent restructuring arrangements, a significant improvement in basic external debt indicators can only be obtained at unacceptable costs for the borrowing country. In this context, any serious attempt to improve the balance-of-payments situation of most countries facing severe debt-servicing problems would have to involve a drastic reduction in spreads, as well as an extension of grace and total amortization periods. A reduction of spreads and an extension of maturities would of course lower average interest and amortization rates and thereby contribute towards reducing debt/export (or debt service) ratios and other basic relative indicators.

105. As far as the interest cost of restructuring is concerned, it must not be forgotten that there is a possibility of substantially reducing spreads without imposing direct losses on creditor banks. Effective spreads, defined as the effective difference between the lending rate and banks' funding costs, are, as a matter of fact, substantially larger than publicly announced spreads over interbank rates. As previously stated, in operations recently negotiated by Brazil, for instance, available information suggests effective spreads of about 4 percentage points. Refinancing of debt service at rates several percentage points lower than those currently practised would therefore not necessarily imply negative margins for creditor banks and could significantly contribute towards reducing the average cost of the debt.

106. Nevertheless, the fundamental determinant of the cost of international credit is not the spread, but the level of basic interest rates, which essentially reflects the evolution of monetary and fiscal policies and inflationary expectations in the United States. If United States interest rates rise substantially above present levels, a mere reduction of spreads will probably not be sufficient to ensure an average debt cost compatible with a favourable evolution of debt ratios. In fact, the interest shown by United States monetary authorities in partial interest capitalization schemes is probably related to the perception that the recent and prospective behaviour of United States interest rates may endanger present restructuring arrangements. From this point of view, capitalization of interest can be seen as a way of restoring the Federal Reserve's freedom of action. For this reason, an interest capitalization scheme, albeit partial, would reinforce the tendency towards a more restrictive monetary policy in the United States -- evidently at the cost of a more rapid increase of international debt and of bank exposure in "problem countries".



107. In this context, it becomes essential to emphasize that relatively moderate proposals, such as the one presented in this section, could prove to be insufficient, and one should not exclude the possibility that it may eventually become necessary to refinance debt service at interest rates below banks' borrowing costs. It is worth mentioning, however, that the three-point scheme discussed in this section would necessarily involve a sharing by banks of the burden of dealing with debt problems. In fact, full capitalization of interest on medium and long-term bank debt implies a compulsory increase in their gross exposure at a rate determined by the level of international interest rates. It would of course be up to the banks and the supervisory authorities whether or not to write-down these loans or build-up loan loss reserves against them. Moreover, the banks would of course have to make concessions in the form of drastically lower spreads and longer maturities. Finally, although banks would suffer no direct losses in the form of negative margins, an unfavourable reaction of depositors and stock markets could seriously affect the more heavily exposed institutions. Once again, it would be up to the governments and monetary authorities of the United States and other industrialized countries to decide whether or not to absorb these losses. In any case, the sort of debt restructuring scheme proposed in this section has the advantage of being essentially independent of the goodwill and political initiative of lending country governments and of not requesting concessional interest rates from commercial lenders.

#### Viability of an extended debt restructuring scheme

108. Assuming that international interest rates do not increase much above present levels, it can be shown that the three basic points referred to at the beginning of the present section -- full capitalization of interest payments on medium and long-term bank debt, drastic reduction of spreads, and extension of maturities -- may effectively offer the prospect of a lasting solution to present problems. One of the objections frequently raised against capitalization of interest is that it would lead to a rapid growth of the debt and simply postpone or even aggravate the problem. This sort of argument, however, reflects a misunderstanding of the central elements of the present situation. If the long-term nature of the debt problem is recognized, if one accepts that it cannot be solved by a sharp reversal of the flow of resources between debtor countries and the international banking system, it necessarily follows that the growth of debt in absolute terms must be seen as inevitable.

109. What really matters is the behaviour of the main debt ratios over time. It can be shown that if certain basic conditions are met, the above-mentioned three-point debt restructuring scheme is perfectly compatible with a significant improvement in the main relative indicators, and does not necessarily lead to an unmanageable growth in the level of debt. On the contrary, a five-year consolidation period could be sufficient to prepare the conditions required for a gradual normalization of relations between the banking system and countries currently experiencing balance-of-payments crises.



110. The final outcome would of course be critically dependent on the policies adopted by the debtor countries and on the behaviour of major external variables during the consolidation period. Given present depressed levels of international liquidity, debtor countries would have to attach a high priority to accumulating a substantial amount of reserves in this period. Since no significant net foreign capital inflows would be forthcoming, the accumulation of reserves would have to be financed with internal resources. Even with full capitalization of interest due on medium and long-term bank debt, exports would therefore have to be kept well above imports of goods and non-factor services. This means of course that an outward transfer of real resources, as defined in section IV, would continue to take place. But this transfer, instead of financing interest payments, would be used to restore international reserves and would in any case be substantially lower than the level of transfers required under present approaches to rescheduling.

111. Besides accumulating reserves, debtor countries would of course have to sustain a continuous policy of export promotion in a systematic effort to avoid an excessively large gap between average external interest rates (which will probably remain at abnormally high levels) and export growth rates. Assuming a significant increase in exports and the above-mentioned substantial reduction in the outward transfer of real resources, imports could then grow at substantially higher rates during the consolidation period. This rapid growth of imports would at the same time significantly support the struggle against inflation and enable the countries to resume economic growth.

112. Despite the faster increase of imports, major debt indicators would tend to improve significantly during the consolidation period. Given a continuous policy of export promotion and reserve accumulation, net foreign debt (defined as the difference between gross debt and reserves) would increase at an annual rate significantly lower than average interest rates and export growth rates. Debt service would also fall relatively to exports, reflecting the reduction in the debt-to-export ratio and lower interest and amortization rates. In fact, even if basic international interest rates continue at current abnormally high levels, substantially lower spreads and longer grace and amortization periods could be expected to affect favourably average interest and amortization rates. Debt service would fall even more when compared to reserves, and the latter would increase substantially in relation to imports. In short, despite the growth of imports and of foreign debt in absolute terms, the overall situation of the external sector of these economies could improve substantially during the consolidation period.

113. One of the basic implications of the foregoing analysis is of course the fundamental importance of the domestic effort involved in restoring the level of international reserves. The freedom of action that would result from a full capitalization of interest payments on medium and long-term bank debt would have to be used not only to achieve a faster increase of imports, but also to guarantee a substantial increase in reserves. The latter is an indispensable condition, not merely from the point of view of improving basic relative indicators, but also to regain control over the external accounts and over exchange

rate policy, and for the protection of the debtor country's basic interests and national sovereignty. If this basic condition is met, and if an active export promotion policy is maintained, an extended rescheduling scheme would produce a significant improvement of the country's external accounts in the medium run. During a five-year consolidation period, the debtor country would be able to increase the level of activity and of imports, accumulate substantial liquid reserves and produce a significantly favourable evolution in the basic external indicators. In this context, it would then be possible to initiate a process of gradual normalization in the country's relations with international financial markets, progressively reducing the share of debt service subject to automatic renewal and gradually re-establishing normal access to medium and long-term credit flows.

114. One must not, however, lose sight of the fact that the evolution of the external accounts is always extremely sensitive to the behaviour of variables which are clearly not under the control of policy-makers in the debtor countries, such as international interest rates, the level of external demand, the terms of trade, etc. It must again be emphasized that if, for instance, international interest rates, which are already at extraordinarily high levels, continue to rise, refinancing of debt service at rates lower than banks' funding costs may eventually become inevitable. In fact, a large and growing discrepancy between international interest rates and the growth rate of world exports would make it extremely difficult, or even impossible, to arrive at a solution to the debt problem by means of relatively moderate proposals, such as the one presented in this paper.

115. At any rate, it appears to be indisputable that there is an urgent need to go beyond current "rescue packages". If there exists any intention of moving from short-run crisis management towards a real attempt to solve the serious problems created by the international debt crisis, a radical revision of present procedures will be indispensable.

FOOTNOTES

1. These figures refer to all publicly announced Eurocurrency loans (including stand-by facilities or committed credit lines) with an original maturity of more than one year. See Morgan Guaranty Trust Company of New York, World Financial Markets, January 1984, pp. 1 and 2.
2. "The IMF has increased total lending in the 1981-83 period of financial distress in the third world and tight liquidity worldwide, as it did in the aftermath of the 1973 oil shock. However, the magnitude of the resources supplied by the Fund is often less important than its role as a catalyst. In the past this has meant giving a 'seal of approval' to countries that have agreed to follow particular programmes of needed policy changes, enabling them to borrow from banks and other sources. In the financial packages of the past two years, the Fund has gone a step further. In these cases, as a precondition to the IMF stamp of approval to a particular debtor country and to the availability of IMF resources, not only must the country agree to a set of policies, but the banks to which the country is indebted also must agree to extend new loans. In this sense, the IMF is 'bailing in' the banks, rather than 'bailing them out.'" Economic Report of the President, Transmitted to the Congress, February 1984, together with the Annual Report of the Council of Economic Advisers, United States Government Printing Office, Washington, D.C., 1984, pp. 80-81.
3. For a recent discussion of the phenomenon of forced lending see, for instance, William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, Washington, D.C., September 1983, pp. 73-82.
4. Given a United States prime rate of 12.5 per cent, a nominal spread of 1.75 per cent over prime, quarterly payments of interest and a flat fee of 1 per cent, the total effective cost for Brazil can be estimated at 15 per cent p.a. Assuming that banks can obtain funding at about two percentage points below the so-called prime rate, the effective annual funding cost would be about 11 per cent. It should be noted, moreover, that this rough estimate does not include gains obtained through special fiscal rebates. In fact, a number of banks use tax receipts obtained in borrowing countries to significantly increase the net profitability of their international operations.
5. Rough estimate based on the exclusion of bridge-loans advanced in late 1982 and of changes in short-term bank lines. The share of banks in total interest payments made by Brazil was estimated on the basis of their share in the country's total foreign debt.
6. See, for instance, J.de Larosière, "Resolving the World's Debt Problems: Adjustment, Financing and Trade", remarks at the Los Angeles Chamber of Commerce, Los Angeles, 21 July, 1983, in International Monetary Fund, External Debt in Perspective, Washington, D.C., September 1983, p. 40. In the case of Chile, however, new loans represented an increase of approximately 11 per

cent in net bank commitments. Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt", mimeo., E/CEPAL/G 1299, p. 59.

7. J.de Larosière, "Adjustment Programs Supported by the Fund: Their Logic, Objectives, and Results in the Light of Recent Experience", remarks before the Centre d'Etudes Financières in Brussels, 6 February, 1984, in IMF Survey, 6 February, 1984, p. 46.
8. From 1976 to 1981, international bank claims as measured by the Bank for International Settlements increased at an average annual rate of 23 per cent. International Monetary Fund, International Capital Markets, Development and Prospects, 1983, Washington, D.C., July 1983, Occasional Paper No. 23, pp. 3 and 4. The rate of growth fell to 10 per cent in 1982 and to only 8.5 per cent in 1983. Bank for International Settlements, "International banking developments - fourth quarter 1983", mimeo., Monetary and Economic Department, Basle, April 1984, p. 4.
9. Paul A. Volcker, "How Serious is U.S. Bank Exposure?", in Challenge, May-June 1983, p. 15.
10. Fortune, 16 April, 1984, p. 82.
11. IMF Staff report, dated 10 February, 1983, disclosed as an appendix in Ernane Galvêas, A Crise Mundial e a Estratégia Brasileira de Ajustamento do Balanco de Pagamentos, Exposicao do Ministro da Fazenda no Senado Federal em 20/03/83 (Table 10).
12. In a telex sent to Brazil's bank creditors in October 1983, the Fund's Managing Director claimed that, under certain assumptions, Brazil would be able to balance her current account in 1987-88. See telex sent by Jacques de Larosière to Brazil's bank creditors on 7 October 1983, fully transcribed in Gazeta Mercantil, 22-24/10/83, p. 12.
13. U.S. Congress, Economic Report of the President - 1984, op. cit., pp. 78-79.
14. Economic Commission for Latin America, op. cit., pp. 74 and 75. For data on the terms of recent bank debt restructurings see International Monetary Fund, Recent Multilateral Debt Restructurings with Official and Bank Creditors, Washington, D.C. December 1983, Occasional paper No. 25, pp. 24-26 and 35-42.
15. U.S. Congress, Economic Report of the President - 1984, op. cit., p. 83.
16. The recent experience of Venezuela is a well-known example of the difficulties that creditors may encounter when facing a country with substantial liquid reserves. The Venezuelan Government has so far refused to accept the adjustment policies required by the IMF, whereas Venezuela's foreign bank creditors reject any formal rescheduling agreement without a prior agreement between Venezuela and the IMF. Economic Commission for Latin America, op. cit., pp. 63-65.



17. Paul A. Volcker, "How Serious is U.S. Bank Exposure?", in Challenge, May-June 1983, p. 14.
18. Richard S. Dale and Richard P. Mattione, Managing Global Debt, The Brookings Institution, Washington, D.C., 1983, p. 13.
19. Federal Financial Institutions Examination Council, "Statistical Release", mimeo., December 1982.
20. Jack M. Guttentag and Richard J. Herring, "Disclosure Policy and International Banking", Brookings Discussion papers in International Economics, No. 7, The Brookings Institution, Washington, D.C., mimeo., December 1983, pp. 23-26 and pp. 32-33.
21. Federal Financial Institutions Examination Council, "Statistical Release", mimeo., November 1983.
22. Cf. Table I.2 and Federal Financial Institutions Examination Council, "Statistical Release", mimeo., December 1982.
23. William R. Cline, op. cit., p. 98.
24. The total value of these banks' claims on 27 countries (Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, Honduras, Jamaica, Liberia, Malawi, Mexico, Morocco, Nicaragua, Nigeria, Peru, Philippines, Poland, Romania, Senegal, Sudan, Turkey, Uruguay, Venezuela, Yugoslavia, Zaire and Zambia) reached \$US 58,380 million in December 1982. Federal Financial Institutions Examination Council, "Statistical Release", mimeo., June 1983.
25. The Internal Revenue Service has taken actions that reduce incentives to constitute reserves. Since 1969, the tax deduction that banks can take for contributions to reserves has been reduced by three-fourths. "Is Accounting Legerdemain Impeding Resolution of Foreign Debt Problem?", in National Journal, 17/12/83, p. 2618.
26. William R. Cline, op. cit., p. 99. Richard S. Dale and Richard P. Mattione, op. cit. p. 37.
27. Jack M. Guttentag and Richard J. Herring, "The Current Crisis in International Banking", Brookings Discussion Papers in International Economics, No. 8, The Brookings Institution, Washington, D.C., mimeo., December 1983, p. 14. "International lending poses particular problems because risks are seldom realized but instead are cumulated and deferred through the rescheduling process. Therefore, loan quality can deteriorate without this being reflected in banks' published accounts". Richard S. Dale and Richard P. Mattione, op. cit., p. 37. However, this sort of manoeuvre hasn't staved off a significant decline in the prices of bank stocks. Fortune, 16 April 1984, p. 83; National Journal, 12/17/83, pp. 2617 and 2619-20.
28. Fortune, 16 April 1984, p. 82. Chase Manhattan Bank committed itself to lend nearly \$US 350 million to Argentina, Brazil and Mexico in 1983, a figure equivalent to about 50 per cent of pretax profits. Ibidem.

29. As is well known, United States regulations generally compel banks to record as "non-performing assets" loans with interest overdue for more than 90 days. However, these rules are probably not as inflexible as they are sometimes made out to be. It should be mentioned that in 1983 state-chartered New York banks managed to avoid a substantial deterioration in their published accounts by obtaining a change in state legislation pertaining to the classification of loans. In the third quarter of 1983, these banks persuaded the state to extend from 60 to 90 days the deadline after which a bank must cease accruing interest on an overdue loan. This change seems to have resulted from the existence of a large volume of loans to Brazil on which interest arrears exceeded the 60-day limit. Without the change, large New York banks such as Chase Manhattan and Manufacturers Hanover would have had to face a sharp increase in the amount of non-performing loans, National Journal, 12/17/83, p. 2618.
30. National Journal, 12/17/83, p. 2620. Current accounting practices may also reflect the perception that United States supervisory authorities would not allow a major bank to collapse. If banks can expect the government to eventually absorb at least part of the losses, they will of course tend to defer indefinitely the establishment of adequate reserves and the adoption of write-down policies. Ibid, p. 2621.
31. Euromoney, April 1984, p. 7. National Journal, 12/17/83, p. 2620.
32. William R. Cline, op. cit., p. 99.
33. International Monetary Fund, International Capital Markets, Developments and Prospects, 1983, op. cit., p. 16.
34. Ibidem. In Japan, banks were asked to provision against country risks out of after-tax profits. Ibidem.
35. The following observations are partly based on interviews with several banks in Frankfurt, Düsseldorf, Munich and Rio de Janeiro from February to April 1984.
36. The use of hidden reserves must be seen as a smoothing device whereby banks underreport profits or capital gains in order to be able to eventually underreport losses or even transform them into profits. Belgium, the Federal Republic of Germany, Japan, Luxembourg, the Netherlands and Switzerland are some of the countries in which banks are allowed to maintain hidden reserves. They are not permitted in the United States, Canada and Denmark. Jack M. Guttentag and Richard J. Herring, "Disclosure Policy and International Banking", op. cit., pp. 26-29.
37. George Soros, "The International Debt Problem: Diagnosis and Prognosis", mimeo., Morgan Stanley, July 1983, pp. 14 and 15.
38. See, for instance, statement by Wilfred Guth, co-chairman of the Deutsche Bank, in "Alternativen zur Methode des Fresh Money", Börsen-Zeitung, 26/01/84.

39. For a German banker's arguments in favour of interest capitalization and other changes in rescheduling practices see, for instance, article by Werner Blessing, a member of the Board of Managing Directors of Deutsche Bank, "Umschuldungsaktionen dürfen nicht zu kurzatmig angelegt werden", in Handelsblatt, I + M Anlage, Nr. 82, 26 April 1984, pp. 2-5.
40. "(...) the Federal Reserve Board and the Comptroller of the Currency indicated that for bank regulatory purposes they will consider private loans on which interest payments in pesos have been made to Banco de Mexico as current 'assuming a satisfactory overall structure resulting from the responses to the Mexican request for the new money facility by the international banking community'. The United States banks have over \$11 billion in outstanding loans to private Mexican borrowers. Under the rules normally applied by the United States regulatory agencies such loans would have to be placed on 'non-accrual status' once interest payments were more than 90 days overdue, thereby reducing bank earnings." Federal Reserve Bank of Chicago, International Letter, Number 489, 17 December 1982, p. 3.
41. Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt", op. cit., pp. 65 and 66.
42. See, for instance, Wilfred Guth, "Challenges to the International Financial System", Speech given at the Royal Institute of International Affairs, London, 1 June 1983, mimeo., p. 6.
43. "The War Among Brazil's Bankers", in Fortune, 11 July 1983, p. 52.
44. Figures quoted refer to June 1983. Federal Financial Institutions Examination Council, "Statistical Release", mimeo. November 1983.
45. Jack M. Guttentag and Richard J. Herring, "the Current Crisis in International Banking", op. cit., p. 5.
46. William R. Cline, "International Financial Rescue: Viability and Modalities", mimeo., see Part II of the present paper. Technically, each bank's new lending confers an external economy on other banks by helping shore up the quality of loans outstanding to "problem countries". Banks that do not participate in forced lending arrangements benefit at the expense of those that do.
47. Preliminary estimates made by ECLA on the basis of official data. The data on inflation rates relate to the variation in consumer prices (Dec.-Dec.). Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt", mimeo., E/ECLA/G.1299, p.4.
48. Excludes debt renegotiations with commercial banks concluded by Poland and Cuba in 1983. The above-mentioned figures refer to multilateral debt renegotiations of World Bank member countries with commercial banks and with the Paris Club. The World Bank, World Debt Tables: External Debt of Developing Countries, Washington, D.C., January 1984, p. xviii.

49. The list of countries that have suspended debt-servicing or rescheduled their foreign debts in 1982-1983 includes 16 countries from Latin America (Argentina, Bolivia, Brazil, Chile, Costa Rica, Cuba, Dominican Republic, Ecuador, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Peru, Uruguay, and Venezuela), 13 from Africa (Central African Republic, Liberia, Madagascar, Malawi, Morocco, Niger, Nigeria, Senegal, Sudan, Togo, Uganda, Zaire, Zambia), 3 from Eastern Europe (Poland, Romania, Yugoslavia), and 2 from Asia (Philippines and Turkey). International Monetary Fund, Recent Multilateral Debt Restructurings with Official and Bank Creditors, op. cit., pp. 11, 16 and 23; The World Bank, op. cit., p. xviii.
50. The causes of the sharp reduction of international bank credit and its relationship with the evolution of the world economy have been discussed in previous papers. See, for instance, Paulo Nogueira Batista Jr., "Crise Financeira Internacional e Transferências de Recursos Reais", in Revista de Economia Política, Vol. 4, No. 3, julho-setembro/84, pp. 127-136. For a retrospective view of the recent evolution of international banking, see Bank for International Settlements, Fifty-Third Annual Report, Basle, June 1983, pp. 118-131.
51. Bank for International Settlements, "International banking developments - fourth quarter 1983", mimeo., Monetary and Economic Department, Basle, April 1984, p. 10. Figures quoted in text refer to loans made by banks located in the BIS reporting area, i.e., Group of Ten countries, Austria, Denmark, Ireland, Luxembourg, Switzerland, and the branches of United States banks in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore.
52. A. W. Clausen, "Priority Issues for 1984", mimeo., remarks before the Davos Symposium, Davos, Switzerland, 26 January 1984, p. 7.
53. Ibid., pp. 7 and 8.
54. See Rubem Almonacid and Maria Cristina R. Pinotti, "A Inflação Internacional Distorce os Dados do Balanço de Pagamentos do Brasil", in Conjuntura Econômica, Vol. 34, no. 1, January 1980, pp. 80-84. International Monetary Fund, External Indebtedness of Developing Countries, Washington, D.C., May 1981, Occasional Paper No. 3, Appendix II: Inflation and Debt Service, pp. 42-45; G. Russell Kincaid, "Inflation and the External Debt of Developing Countries", in International Monetary Fund, External Debt in Perspective, Washington, D.C., September 1983, pp. 12-15.
55. In this case, domestic absorption, although not greater than GDP, still exceeds GNP, defined as the total product appropriated by residents of the country, by a margin which corresponds to the deficit on current account, i.e., to the difference between net factor payments and net exports of goods and non-factor services.
56. By way of simplification, equation (3) ignores unilateral or unrequited transfers, factor services except interest, profits and dividends, exchange-rate changes, variations in the price of gold and reserve accumulation on the basis of domestically produced gold.



57. By way of simplification, equation (5) ignores other factor services, unilateral transfers, exchange-rate variations, changes in the price of gold, reserve accumulation on the basis of domestic production of gold and net outflows related to foreign loans granted by residents.
58. For an analysis of the recent evolution of monetary and fiscal policies in the United States and its relationship to the level of interest rates, see, for instance, OECD, Economic Outlook, 34, December 1983, pp. 23-32 and 76-84.
59. Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt", mimeo., op. cit., pp. 60-63.
60. By the end of 1982, as much as 62 per cent of the total disbursed external public debt of countries in Latin America and the Caribbean carried variable interest rates, i.e., rates that are periodically readjusted in line with changes in basic market rates such as the London Inter-Bank Offered Rate (LIBOR) or the United States prime rate. Concessional loans made up only 6.7 per cent of total debt. The World Bank, World Debt Tables: External Debt of Developing Countries, op. cit., p. 153.
61. Figures for external debt and GDP were taken or inferred from ECLA and IBRD data. Comissão Econômica para América Latina, "Balanco preliminar da economia latino-americana durante 1983", mimeo., Tables 1 and 13; The World Bank, op. cit., p. 152; and Economic Commission for Latin America, "Adjustment Policies and Renegotiation of the External Debt", op. cit., p. 46. The 13 per cent average interest rate is based on the average cost of foreign loans to the public sector in Latin America and the Caribbean. (See, The World Bank, op. cit., p. 153.) GDP for 1983 was estimated on the basis of ECLA's preliminary estimate of real growth and of the change in the output deflator in the United States. Given the sharp reduction of international reserves in 1981-1983 (see Table I.7), it was also assumed that there was no significant difference between gross and net debt at the end of 1983.
62. An expression analogous to equation (7) may be obtained by multiplying both sides of equation (6) by the ratio of net debt to exports:

$$\frac{X - M}{X} = (i - \frac{\Delta DL}{DL}) \cdot \frac{DL}{X}$$

The share of exports taken up by the outward transfer of resources depends, therefore, on the interest rate, the growth rate of debt and the ratio of debt to exports.

63. The structural nature of the United States' fiscal problem is recognized by the United States Government itself: "Vigorous economic growth can eliminate the cyclical component of the deficit. But without legislative action, the structural component is likely to grow just as fast as the cyclical one shrinks. The Administration's economic projections imply that the budget deficit

will remain roughly \$200 billion a year -- or about 5 per cent of GNP -- for the rest of the decade unless there is legislative action to reduce spending or raise revenue. Deficits of that size would represent a serious potential threat to the health of the United States economy in the second half of this decade and in the more distant future". Economic Report of the President - 1984, op.cit., p. 35. This same document estimates that the deficit's structural component would increase from 52 per cent of the deficit in 1983 to 92 per cent and 102 per cent, respectively, of the total deficit anticipated for 1988 and 1989. Ibidem, p. 36. See also Budget of the United States Government, FY 1985, pp. 2-14 and 2-15.

64. Organisation for Economic Co-operation and Development, OECD Economic Surveys: United States, December 1983, pp. 33 and 34.
65. See, for instance, Morgan Guaranty Trust Company of New York, World Financial Markets, December 1983, pp. 1-8.
66. A. W. Clausen, op. cit., p. 5; J. de Larosi re, "Resolving the World's Debt Problems: Adjustment, Financing and Trade", op. cit., p. 41.
67. Exports to the developing countries account for 28 per cent of the total exports, and 6 per cent of the national income of the industrialized countries. A.W. Clausen, op. cit., p. 5
68. Organization for Economic Co-operation and Development, Economic Outlook, op. cit., pp. 42-45.
69. Helmut Mayer, "Financial flows to developing countries: trends, problems and future outlook", mimeo. Bank for International Settlements, Monetary and Economic Department, August 1983, p. 1.
70. National Journal, 12/17/83, p. 2620.
71. George Soros, op. cit., p. 10.
72. The consolidation period of a restructuring arrangement is defined as the period of time encompassing the original due dates of all the debt that is refinanced or rescheduled in the arrangement. International Monetary Fund, Recent Multilateral Debt Restructuring with Official and Bank Creditors, op. cit., p. 25.
73. It should be kept in mind that Paris Club agreements usually include the rescheduling or deferment of almost all interest payments on governmental loans or loans guaranteed by the government or the official agencies of the participating creditor countries. Interest owed to multilateral institutions such as the IBRD and the IDB, which continue to make net financial transfers to debtor countries, would be excluded from the capitalization scheme. In order not to adversely affect foreign trade financing, interest on short-term commercial credits would also continue to be paid on a cash basis. In addition, debt-service payments related to bonds, which constitute a small fraction of the foreign debt of developing countries, could also be exempted from the capitalization scheme.

- 74. See above, paras. 39-41 and 48-49.
- 75. See above, paras. 21-22.
- 76. Financial Times, 2 May 1984, pp. 1, 14, and 16.

## PART II

INTERNATIONAL FINANCIAL RESCUE:  
VIABILITY AND MODALITIES

William R. Cline

1. The international financial community is now engaged in a historic debate between those who consider the problem of international debt to be broadly manageable under the ad hoc strategies employed to date, and those who foresee a failure of this approach and propose more fundamental restructuring instead. The advocates of more fundamental reform warn that if action is delayed the ultimate damage to the system will be much greater, while the advocates of the current strategy maintain that the implementation of more extreme approaches would precipitate unnecessary damage to creditors and debtors. Even if the more extreme alternatives of fundamental reform are rejected, however, important questions remain about the adequacy of the institutions and procedures that have been used to address the debt problem.

2. Elsewhere I have examined the problem of international debt generally, and developed a projection model for the 19 largest debtor countries. 1/ The purpose of this paper is to focus on the specific nature of the major financial rescue programmes, to draw a judgement about their viability over the longer term, and to examine the particular institutional mechanisms and modalities employed to deal with debt crises. The analysis here emphasizes the four major rescue missions: those for Argentina, Brazil, Mexico, and Yugoslavia. These four countries account for 30 per cent of the total external debt of developing countries and Eastern Europe, and for approximately 60 per cent of the debt owed to commercial banks by countries that have experienced debt-servicing disruptions in 1982-83. 2/

I. The Rescue Packages, 1982-83

3. The debt problem erupted in full force in mid-1982 when Mexico temporarily suspended payment on principal on its external debt of approximately \$80 billion. By the end of 1982, 34 countries were in arrears. The amount of payments rescheduled soared from annual rates of \$5 billion or less in earlier years to approximately \$90 billion in 1983. By 1983 countries accounting for two-thirds of the debt owed by developing and East European countries to foreign banks had been forced to interrupt normal debt-servicing. 3/

4. The major source of the debt problem was international. For non-oil developing countries, from 1973 to 1982 debt rose by \$482 billion. Of this amount, \$260 billion could be attributed to oil price increases in excess of general inflation, and \$141 billion to global economic shocks in 1981-82 (\$41 billion in interest costs above traditional real interest rate levels, \$79 billion in terms of trade loss, and \$21 billion in export volume loss). 4/ Despite the obvious



adverse impact of global economic conditions, however, national policies also played a role in causing the crisis. The simplest evidence is that some countries not otherwise in unusually advantageous positions have managed to escape debt disruption, including Colombia and the Republic of Korea, as well as several other Asian debtor countries. The influences of domestic policy and external shock in precipitating the debt crises of the four major countries examined here are discussed in detail elsewhere. <sup>5/</sup> This section focuses on the actual rescue measures implemented in 1982-83 for the largest debtor countries.

#### A. Mexico

5. By 20 August 1982, Mexico had received pledges of emergency financial support. The United States Government committed \$1 billion in prepayment for purchases of oil for the strategic petroleum reserve and another \$1 billion in Commodity Credit Corporation agricultural loans. The Bank for International Settlements (BIS) provided \$925 million in short-term bridge loans from European central banks, co-ordinated with loans of the same size from the United States Federal Reserve. In addition, the prospective flow of export credits to Mexico added another \$2 billion in official support.

6. At the same time, Mexico proposed and the banks accepted a 90-day moratorium on principal payments on its external debt, eventually extended to 23 March 1983 and then to 25 August 1983. The Government also imposed exchange controls to stop capital flight. Mexico then sought a comprehensive debt rescheduling, covering \$19.5 billion in short-term and long-term public debt repayments of principal due from 23 August 1982 through 31 December 1984 and another \$15 billion in private debt due over the same period. The Government eventually set up special peso accounts for servicing of private debt. In addition, the Government sought \$5 billion in new loans from foreign banks, an expansion of their exposure by 7 per cent. The full bank package was finally obtained by February 1983, with the participation of 530 foreign banks.

7. For its part, the IMF provided a programme composed of \$3.7 billion from the Extended Fund Facility, and \$200 million from the first credit tranche. The IMF made its participation conditional on commitment from the private banks to provide their package of rescheduling and new lending. The conditions attached to the IMF programme included reduction of Mexico's budget deficit from 16.5 per cent of GDP in 1982 to 8.5 per cent in 1983, 5.5 per cent in 1984, and 3.5 per cent in 1985. After some anguish that the whole package would fall apart after the outgoing administration of President Lopez Portillo nationalized Mexican banks on 1 September, in November the IMF and Mexico reached agreement on the programme. The new administration of President de la Madrid in December established a forceful adjustment programme implementing the commitment to the IMF and, in addition, adopting a realistic but flexible exchange rate regime as well as a tough wage policy to avoid an inflationary spiral.

8. The hallmark of the Mexican package was immediate, forceful action by the Government and a prompt response by the international financial community. By the autumn of 1983 that action appeared to be successful. There had been no need for programme revisions or renewed calls for additional financing. During 1983 Mexico more than met its external goals (achieving a current account surplus of \$3.7 billion instead of the planned \$3 billion deficit) mainly because of an extremely sharp reduction in imports and partially at the expense of a severe recession (imports declined by 38 per cent and GDP fell by 4 per cent in 1983). 6/ It also achieved the targets for domestic adjustment, and although inflation for 1983 was still 92 per cent (following 100 per cent in 1982) the monthly rate showed significant deceleration. Because of its model adjustment success, by the September, 1983 meetings of the World Bank and IMF, Mexico was the darling of the international financial community, in vivid contrast to its position as the primary threat to the financial system at the meetings one year earlier.

9. Analysts have compared Mexico's energetic measures favourably with the more gradual strategy adopted by Brazil, and there is some merit in this judgement. 7/ However, as analyzed below, the comprehensive nature of Mexico's rescheduling (\$35 billion out of total debt of approximately \$82 billion) means that there will be a bunching of large amortization payments in the late 1980s, possibly increasing future difficulties as the price for current relief.

#### B. Brazil

10. The Brazilian rescue process was less comprehensive and more gradual than that for Mexico, although it involved comparable efforts and commitment of resources by industrial countries and international agencies. Perhaps two central influences accounted for the greater gradualism. First, Brazil had maintained exchange controls as a normal policy, and therefore never faced the same ultimatum for immediate action posed by the Mexican circumstance of massive capital flight under exchange rate convertibility. Second, even through late 1982 there was a general perception that Brazil's difficulties were induced by market nervousness caused by the Mexican crisis, and that on the fundamentals Brazil's situation was more favourable -- a perception increasingly revealed as erroneous. Unlike the Mexican case, in Brazil the financial package and adjustment programme suffered setbacks in 1983, and the "rescue operation" has consisted of an ongoing series of episodes in addition to a set of initial measures.

11. Financial pressure on Brazil began in mid-1982 when interbank deposits in foreign branches of Brazilian banks began to decline (from a level of approximately \$10 billion, they had fallen to \$6 billion by year-end). As capital flows declined after the Mexican crisis, the Brazilian Government finally sought IMF assistance, despite its earlier efforts to adjust without IMF support. 8/

12. By mid-December the liquidity squeeze was so great that the United

States Treasury stepped in with a 90-day loan of \$1.23 billion. In addition, the United States Federal Reserve provided short-term lending of \$400 million and European central banks, through the Bank for International Settlements, another \$1.2 billion.

13. On 20 December 1982, Brazilian officials met in New York with representatives of 125 banks and, on the recommendation of lead banks, requested the following four-point programme: 1) \$4.4 billion in new loans for 1983; 2) rescheduling (over 8 years) of \$4 billion of long-term debt coming due in 1983; 3) maintenance of short-term trade-related credit lines of \$8.8 billion; and 4) restoration of short-term interbank deposits to their June 1982 levels. To cover the period before the new funds could be mobilized, six United States banks provided \$600 million, and 34 other international banks provided \$1.4 billion, in bridge loans. As in the case of Mexico, the IMF conditioned its support on achievement of bank commitment to this package.

14. The IMF package took form relatively rapidly, in retrospect perhaps too rapidly to permit realistic evaluation of its feasibility. The IMF agreed to provide \$4.6 billion over 3 years through the Extended Fund Facility and \$1.3 billion in compensatory finance for depressed export prices. In return, the Brazilian authorities pledged a reduction of budget deficits from 6 per cent of GDP in 1982 to 3.6 per cent in 1983, through reduced farm credit subsidies, cutbacks in budgets of State enterprises, price increases for petroleum products and wheat, and other measures; achievement of a \$6 billion trade balance surplus in 1983; and limitation of domestic credit expansion to 63 per cent over the year. Formal agreement was reached by January 1983.

15. In format, the Brazilian rescue mission was similar to that for Mexico, with participation by all the same major players. The principal difference in the programme's design was its heavy reliance on voluntary maintenance of short-term credit lines (points 3 and 4) instead of outright rescheduling of short-term debt as in the Mexican case.

16. This difference, consistent with a gradualist as opposed to radical approach to the problem, proved to be the Achilles heel of the package. In particular, the banks failed to restore interbank deposits to the \$10 billion mid-1982 level, or even to a subsequent, more modest target of \$7.5 billion; these deposits stabilized at approximately \$6 billion. Largely for this reason, Brazil began to fall into arrears. When it became clear that the large banks were allowing Brazil to accumulate arrears and no longer lending enough to enable it to close its books each day, the Government took the severe measure of a 30 per cent maxi-devaluation in February 1983, even though its IMF agreement had been premised on continued mini-devaluations (although at a "crawl" faster than inflation).

17. In part because of inflationary side effects of the maxi-devaluation, inflation began to rise further. Serious flooding in the South and drought in the Northeast caused agricultural losses and



sharp inflation of food prices. By the end of May, Brazil was not meeting its pledged budget and credit targets, and the IMF suspended payments. The Government responded in June with measures modifying the wage indexation mechanism (ending over-indexation for low wages and "purging" the index of effects of natural disasters). But the IMF judged this change to be inadequate.

18. On 11 July the Bank for International Settlements informed Brazil that it would not renew its bridge loan coming due on 15 July. Facing the possibility of an officially-precipitated default, President Figueredo took the dramatic step of decreeing law 2045 limiting wage indexing to 80 per cent of the consumer price increase.

19. Although the IMF praised this decision, it refused to reinstate the loan drawdowns until the decree-law became confirmed, either by Congressional approval or by expiration of the 60-day period for Congressional review. In the interim, arrears mounted to nearly \$3 billion and United States banks came closer to the 90-day delayed payment demarcation that triggers non-performing status for loans (and therefore non-accrual of interest, reducing reported earnings).

20. In the ensuing period Brazil informed the Paris Club that it would seek rescheduling of official debt. In addition, the United States Government announced an imaginative programme of \$1.5 billion in export credit guarantees that would be available for banks making loans beyond the amounts called for in the general bank packages. The United States Government sought participation by other governments to raise the total to \$2.5 billion.

21. For their part, in the autumn of 1983 the banks initiated a second phase of commitments, amounting to \$6.5 billion in new lending through 1984 and the rescheduling of over \$5 billion in principal due in 1984. Of course, in view of their failure to deliver fully on the original "point 4" relating to interbank deposits, the net amount of new funding envisioned was much smaller. Moreover, the banks had suspended drawdowns on their earlier commitment of \$4.4 billion, because these loans were linked to IMF disbursements.

22. By mid-October 1983, the Brazilian Congress rejected law 2045. Increasing gloom characterized perceptions of the Brazilian case, and sharp reductions in the stock prices of major United States banks reflected this trend. But by early November, the Brazilian Congress approved a substitute measure, which provided 100 per cent indexing for the lowest wage categories and a sliding scale of lesser indexation for higher wages, giving an 87 per cent indexation on average. This resolution broke the impasse, clearing the way for IMF approval and resumption of bank lending. Moreover, Brazil had achieved impressive progress toward the external targets in its adjustment programme; the goal of a \$6 billion trade surplus for 1983 was in the event more than achieved.



23. The difference between the recurrent mishaps of the Brazilian programme and the successful implementation of the Mexican package lay only superficially in programme design. The reliance on interbank deposits was a serious error but could have been corrected by increased new lending under different circumstances. Instead, the more fundamental difference was that for Mexico adjustment was easier than for Brazil. Mexico had experienced high recent growth, while in 1983 Brazil was entering the third year of recession. Mexico had a bloated import bill that could be purged of luxuries, whereas Brazil had already pared imports to the bone.

### C. Argentina

24. Perhaps because its debt was smaller than that of Brazil or Mexico, and in the context of disruption to normal financial relations because of the South Atlantic war, Argentina experienced several months of arrears and debt-service disruption in 1982 before the international community came to its aid. Initial discussion with the IMF began only in September 1982, with agreement, in principle, by October and formal agreement only in January 1983.

25. Aside from its delay, the rescue package for Argentina resembled those for Mexico and Brazil, with financial magnitudes scaled down in proportion to its smaller external debt (\$38 billion). The players were largely the same: the International Monetary Fund, the Bank for International Settlements, and private banks. The Federal Reserve, together with BIS members, offered a \$500 million loan, although in the event Argentina never drew this official loan because of its immediate callability as well as the requirement of collateral in gold.

26. The IMF programme was for only 15 months, in order to leave policy flexibility for a new civilian Government then scheduled to take power in 1984. <sup>9/</sup> Accordingly, Argentina did not exhaust the loans that could have been available to it under a 3-year Extended Fund programme. The IMF package included \$1.65 billion in stand-by loans and \$490 million in compensatory finance. In the programme, Argentine officials pledged to reduce the public sector deficit from 14 per cent of GDP in 1982 to 8 per cent in 1983 and 5 per cent by early 1984 (using IMF measurement), to limit credit growth, cut the external current account deficit to only \$1 billion in 1983, and to maintain realistic interest rates and exchange rates. Although not a criterion for programme evaluation, inflation was assumed to average 160 per cent for 1983.

27. As in the Mexican and Brazilian packages, the IMF conditioned its support on private bank participation. The banks pledged new 5-year lending of \$1.5 billion for 1983. They also granted the rescheduling over 7 years of outstanding arrears (in the order of \$2 billion) as well as public short-term debt (approximately \$7 billion) and long-term debt due in 1983 (approximately \$3.5 billion); and rescheduling over 3 to 5 years of private debt. Argentina's rescheduling was intermediate between those of Brazil and Mexico. Like Brazil, Argentina rescheduled

only one year's repayments (1983) instead of two as in Mexico; but like Mexico, Argentina rescheduled both long and short-term debt, public and private, amounting to approximately half of its total debt (compared with only about 5 per cent of total debt in Brazil).

28. Argentina's rescheduling was not smooth. The Government unilaterally rescheduled on a 5-year basis \$5.5 billion in exchange guarantees in November 1982, as well as \$1.4 billion in swaps in March 1983, and the unilateral nature of these measures disturbed creditors. The new bank loans of \$1.5 billion suffered delays because of the Government's reluctance to remove restrictions on profit remittances by British firms (resolved in August) and because of creditor opposition to an Argentine law giving national creditors preferred status in the event of private bankruptcy. Illustrating the political uncertainties of the Argentine case, a local judge even managed temporarily to jail the President of the Central Bank on grounds that his rescheduling agreement violated Argentine law.

29. During 1983 Argentina's trade performance approximately achieved the goals of the IMF package, with low imports contributing to a trade surplus. Despite accelerating inflation, the IMF approved further drawdowns in the spring, but by autumn it declared Argentina in non-compliance -- in part because of arrears that built up as the consequence of delay in bank disbursements. Inflation turned virulent as firms sought to take price increases before possible controls under a new Government, and by the final quarter further developments in the rescue programme were essentially suspended as all participants waited to see the next move of the newly and resoundingly elected Radical Party Government of President Raul Alfonsin.

30. Overall, although the financial rescue process for Argentina succeeded in staying off the disruption of moratorium, it broadly amounted to a series of false starts and delays. The brightest spot in this confused picture was successful achievement of external sector targets.

#### D. Yugoslavia

31. Financial rescue for Yugoslavia began with its request to the Bank for International Settlements for a loan of \$500 million in September 1982. By January, 14 Western governments had developed a package of \$1.3 billion in official loans. With the United States having taken the lead in the rescue operations for Mexico and Brazil, Switzerland took the responsibility for leading the Yugoslavian package.

32. Yugoslavia entered IMF-sponsored negotiations with the banks, with which the country was already in arrears. By late spring the banks were near agreement on providing \$600 million in new long-term loans as well as \$1.2 billion in refinancing loans to permit the repayment of principal due in 1983. They also agreed to roll over \$1.2 billion in short-term debt until January 1985.

33. The IMF provided \$600 million as the final installment of a \$2.1 billion standby credit dating from 1981. The World Bank committed \$500 million in project and structural adjustment loans. Altogether, the financial support totalled approximately \$6 billion, of which approximately \$3 billion was official.

34. In actual implementation the Yugoslav package suffered from delays not wholly unlike those in Brazil and Argentina. Of the \$500 million BIS loan, disbursement of the final \$200 million was delayed for six months until September because some banks objected to the BIS' requirement of gold collateral as a violation of the country's pledge to banks not to provide better collateral to other creditors. The actual agreements with private banks were not signed until September 1983, because of the refusal of some regional banks to participate.

35. Despite delays in the financing package, the Yugoslav economy showed external improvement during 1983, as hard-currency exports through September rose by 15 per cent while hard-currency imports held constant. The prospects were for a convertible-currency deficit of \$500 million to \$800 million, compared with \$1.4 billion in 1982. However, inflation accelerated to an annual rate of nearly 60 per cent. More broadly, doubts remained about the ability of the national government to take necessary measures, such as tax increases, over the objections of the powerful regional governments.

## II. Medium-term viability

36. The strategic question of the longer term viability of financial rescue is the subject of an analysis I have prepared elsewhere on the basis of balance-of-payments projections for the largest debtor countries. 10/ This section summarizes the findings of those projections. In addition, the discussion here reviews the actual external performance of major debtors in 1983, and considers the feasibility of meeting amortization payments coming due in the late 1980s, as well as the prospects for a return to more normal voluntary bank lending by that time.

### A. Performance to date

37. The external sector performance of the three major debtors since their financial rescue packages began has shown sharp adjustment, although primarily through cutbacks in imports rather than increased exports. In Mexico, imports fell from \$23.9 billion in 1981 to \$14.4 billion in 1982. For 1983 imports were only an estimated \$9 billion. 11/ Accordingly, from 1981 to 1983, the current account swung from a deficit of \$12.5 billion to an actual surplus (estimated at \$3.7 billion), despite the stagnation of exports at approximately \$21 billion as declining oil prices worked against rising non-oil exports.



38. In Brazil, imports have fallen from \$20.5 billion in 1982 to an estimated \$16 billion in 1983. Exports have risen from \$20.2 billion in 1982 to an estimated \$22.3 billion in 1983, a rise of 10 per cent. More importantly, there was a strong acceleration after the February 1983 maxi-devaluation. Whereas exports fell by 4 per cent in the first quarter from the same period in 1982, they rose by 16.2 per cent in the second quarter and 11.5 per cent in the third. <sup>12/</sup> In Argentina, the adjustment was more sharply focused on imports. Imports in 1983 declined in value by 20 per cent from 1982. Exports rose slightly, by approximately 3 per cent. As a result, the reported figures showed a widening trade surplus.

39. For the three countries together, the combined trade balance shifted from a deficit of \$3 billion in 1981 to a surplus of \$22 billion for 1983. This swing of over \$20 billion means that for these three crucial debtor countries, the bulk of external adjustment needed has already occurred. From now on the challenge will be to increase exports to permit a recovery of imports and thereby a resumption of positive growth.

40. Domestic economic results were much less favourable than external performance for these countries in 1983. Real growth of GDP was an estimated 2 per cent in Argentina, -5 per cent in Brazil, and -4 per cent in Mexico; consumer price inflation was 402 per cent, 175 per cent and 92 per cent, respectively. Real per capita GDP in 1983 was below the 1980 level by 13 per cent in Argentina and 12 per cent in Brazil, and 9 per cent below the 1981 level in Mexico. <sup>13/</sup> The severe cuts in domestic income associated with recession and austerity programmes meant serious strains on the political viability of the adjustment process.

41. The external constraint does not necessarily mean economic stagnation over the medium term, however. External adjustment means a need to shift resources from the non-tradeables sector to tradeables (exports and import substitutes). After an initial period when recession occurs because reduced activity is immediate in non-tradeables but there is a time lag before activity picks up in tradeables, there should be renewed economic dynamism from the tradeables sector. <sup>14/</sup> Accordingly, it would be a serious mistake to project into the indefinite future the conditions of economic recession recently experienced in countries such as Mexico and Brazil, and correspondingly wrong to predict political collapse from such stagnation.

#### B. Medium-term prospects

42. In a recent study I have presented a projection model of the balance of payments and external debt of the 19 largest debtor countries. <sup>15/</sup> In the model, each country's exports depend on the OECD growth rate. Export volume responds to OECD growth according to a general relationship estimated for total non-oil real imports in 1961-80. <sup>16/</sup> Real export prices also depend on OECD growth, with differing relationships from each country based on data for the past two



decades. Real imports depend on the country's domestic growth (with a long-term income elasticity of 1.0 and a cyclical elasticity of 3.0). Both exports and imports depend on the real exchange rate (with elasticities of 0.5 and 0.6, respectively). Trade values are affected by world inflation and the strength of the dollar. Oil trade is estimated at base period volumes and assumed prices. The interest burden depends on debt and the level of international interest rates. New borrowing required depends on the current account deficit and reserve accumulation minus direct investment inflows.

43. The central projections assume OECD growth averaging 3 per cent per year in 1984–86, LIBOR falling from 10 per cent to 8 per cent, oil priced at \$29 per barrel through 1985, and a 15 per cent depreciation of the dollar by 1984. With some specific exceptions, domestic growth in debtor countries is assumed to rise from 2.5 per cent in 1983 to 4.5 per cent by 1986. Under this base case, most of the major debtor countries show substantial improvement in debt indicators by 1986. For the 19 countries combined, the current account deficit would decline from 24 per cent to 14 per cent of exports of goods and services by 1986 and the ratio of net debt to these exports would decline from 190 per cent to 160 per cent. Essentially, global economic recovery would buoy the exports of debtor countries sufficiently to permit them not only to return to more sustainable creditworthiness indicators but also to do so under conditions of acceptable domestic growth rates.

44. For key debtors the trends are also favourable. Brazil's ratio of net debt to exports of goods and services declines from approximately 380 per cent in 1982 to 200 per cent; this ratio falls from 370 per cent to 180 per cent in Argentina, from 270 per cent to 230 per cent in Mexico, and from 114 per cent to 52 per cent (including non-convertible currency) in Yugoslavia. The only significant deterioration is for OPEC countries such as Algeria, Indonesia, and Venezuela, whose heavy reliance on oil exports portends weak exports under the assumption of stagnant oil prices. However, experience in 1983 suggests much sharper cutbacks in imports in these countries, and therefore smaller external deficits, than projected in the simulation study.

45. These broadly favourable results depend heavily on global economic performance. If OECD growth is 2 per cent instead of 3 per cent, there is some modest deterioration in debt to export ratios. At 1 1/2 per cent growth, the deficits mushroom to levels that cannot be financed (from an estimated \$53 billion in 1986 for the 19 largest debtors, in the base case, to \$107 billion). If interest rates rise by 5 percentage points, the improvement in debt indicators also disappears. A collapse in the price of oil, after accounting for favourable feedback effects on OECD growth and interest rates, would marginally reduce deficits for the major debtors as a group but still worsen the viability of debt because of the extreme concentration of adverse effects on oil exporters (whereas benefits for oil importers would be more moderate). Failure of the dollar to depreciate from its severely overvalued level <sup>17/</sup> would reduce the improvement of creditworthiness, as dollar prices of traded goods would fail to rise as much as otherwise would be expected. Thus, the return to creditworthiness is by no means assured.

46. Nonetheless, the base-case assumptions are the best estimate of likely global conditions. Indeed, based on past averages, 3 per cent OECD growth in the recovery phase 1984-86 may be too modest an assumption, and relatively robust United States recovery in 1983 suggests that international recovery is indeed beginning. Accordingly, the central estimate should be that the debt problem will show significant improvement as world recovery takes place, and that the problem is best viewed as one of temporary illiquidity rather than fundamental insolvency. The implications of this assessment for public policy on international financial rescue are fundamental. If the projections are broadly valid and the debt problem is one of illiquidity, the past strategy of financial rescue has been based on the proper premise and although the precise tactics of its implementation may not have been ideal, it would be wrong to pursue a radical strategic reorientation toward bankruptcy-like measures that would forgive significant portions of existing debt.

47. Actual experience through late 1983 compared to the forecasts calculated in the projections (completed in April 1983) provides an initial evaluation of the realism of the projections. By far the greater tendency appears to have been overstatement of deficits for countries such as Indonesia, Mexico, and Venezuela, rather than understatement for countries such as Brazil. In the aggregate, actual current account deficits in 1983 for the large debtors appear likely to be as much as 60 per cent smaller than originally calculated in the projection model. 18/

### C. Maturity bunching and conversion to voluntary lending

48. Despite the prospects for improved creditworthiness as world recovery occurs, additional obstacles must be overcome for the present strategy to be viable over the longer term. One potential hurdle is the bunching of maturity payments in the mid and late-1980s that will result from some of the major debt reschedulings.

49. At the present time the banking system is operating on a totally new basis of "involuntary lending." Banks without existing exposure are unlikely to lend to countries in debt-servicing difficulties. But banks already exposed find it rational to lend modest additional amounts to enable the country to avoid default, thereby safeguarding past exposure. Smaller banks tend to believe their own actions will not affect the chances of default even though in the aggregate they do, and accordingly there is a temptation for smaller banks to be "free riders," seeking to benefit from new loans by larger banks without making new loans themselves. Pressure from the IMF, large banks, central banks, and potentially from the debtor country help ensure co-operation by the smaller (and in some instances larger) banks. 19/

50. Involuntary lending should not continue indefinitely, however. By perhaps 1986, the creditworthiness indicators for Argentina, Brazil, and Mexico should be back to acceptable levels below the critical thresholds

associated with past debt reschedulings. 20/ Nonetheless, a return to more normal capital market conditions will pose the challenge of dealing with large amortization, because when lending is voluntary, the rollover of past debt coming due cannot be automatically assured.

51. Because Mexico's rescheduling has been the most extensive among the three large Latin American debtor countries, the medium-term rise in its amortization schedule is the sharpest, with principal repayments rising from zero in 1983 to over \$20 billion in 1987. 21/ Argentina also shows a surge, from zero in 1983 to \$14 billion in 1986. Because Brazil has not formally rescheduled its short-term debt, its profile of amortization is smoother (but higher in early years), running at approximately \$20 billion in 1983-84 and rising to \$28 billion by 1985-86.

52. Despite the bunching of maturities for Mexico and Argentina, the respective magnitudes would appear manageable if the conditions of creditworthiness have been restored. In 1981 Mexico obtained total financing, for amortization plus new borrowing, that was comparable to or greater than the amortization and new borrowing projected for 1987-88. Thus, the current strategy of debt management should not be unduly vulnerable to the prospective concentration of amortization coming due in the mid to late-1980s. It is significant, however, that because of the concentration in the future repayment schedule, Mexico has negotiated considerably longer new lending from foreign banks in 1984 at 10-year maturities. 22/

53. An important related issue is whether it will be possible to return from involuntary to voluntary lending, and when. If no reconversion to a voluntary basis for financial markets could be foreseen even over a period of many years, it would be difficult to support the judgement that the debt problem is one of temporary illiquidity.

54. In the return to voluntary lending, needs for new borrowing by debtor countries must be sufficiently limited that funding can be mobilized from banks on a voluntary basis. Moreover, because at least a subset of smaller banks may wish to withdraw outstanding principal rather than expand their exposure, the group of larger banks that intend to remain active in new financing for the country must be prepared to finance not only the gap in the country's balance of payments (after taking account of direct investment and official lending) but also the amortization payments falling due to the smaller banks choosing to exit. Although this condition may appear extreme, an analysis based on the projections discussed above finds that it should be possible in the period 1986-88. 23/ In particular, if the largest banks accounting for 70 per cent of exposure are prepared to increase their exposure at a rate of 12 per cent in Argentina during 1985-86, 6 to 11 per cent in Brazil during 1986-88, and 9 to 12 per cent in Mexico during 1985-88, it should be possible to cover the countries' capital requirements and at the same time enable the smaller banks accounting for 30 per cent of exposure to receive the amortization due to them on an orderly basis.



### III. Institutions and Procedures

55. On the basis of the evidence to date and the projections cited above, the debt problem should be manageable as international economic recovery proceeds. Under these circumstances, temporary financial rescue is the appropriate remedy, addressed to the problem of illiquidity. More radical debt write-offs remain inappropriate, unless failure of global recovery or other economic shocks transform the problem into one of more fundamental insolvency. Accordingly, the basic premise of international action to date appears sound; interim financial rescue is the appropriate strategy.

56. Many questions remain, however, about the implementation of financial rescue. 24/ The experience of 1982-83 revealed some patterns of action but nonetheless reflected an essentially ad hoc process, with different provisions for different countries. One important question is whether it would be possible to introduce more systematic procedures. Another issue concerns the cost of financial rescue, especially in terms of additional interest charges and fees. Another issue is the appropriate amount of debt rescheduling. Questions also remain about the ongoing involvement of the private banks and the International Monetary Fund.

#### A. Operational structure

57. Beginning with the case of Mexico, during 1982-83 the international financial community developed a pattern of emergency action to deal with major debt crises. The evolving model for debt rescue involved four sets of actors: the debtor countries, the private banks, industrial country governments, and international financial institutions. The debtor country was expected to adopt strong adjustment measures. The banks were expected to reschedule loans coming due and extend additional new money. The Western governments provided some direct financing, at first through short-term loans from central banks but later through export credit agencies. And the International Monetary Fund co-ordinated the rescue effort, not only by making its own resources available and requiring a corresponding adjustment programme by the country, but also, in a historically significant change, by forcing private banks to reschedule and extend new loans under the threat of non-participation by the IMF unless they did. The World Bank and Inter-American Development Bank added their resources, usually after a considerable delay beyond the initial rescue effort. In retrospect, despite the "ad hoc" image of these efforts, they amounted to an impressive pattern of systematic action by the international financial community to deal with an urgent threat.

58. There are important limitations to the extent to which the process could or should be made more systematic. A fundamental problem is that the more automatic debt rescheduling and financial rescue become, the greater is the "moral hazard" of inducing incautious policies by borrowing countries and, depending on the extent of automatic public



support, by private banks. Because of the moral hazard problem, debt rescheduling and financial rescue are inherently conducted on a case-by-case basis, with the specifics to be negotiated among the central actors in each instance. The same consideration means that financial rescue is usually after-the-fact of a financial disruption, rather than anticipatory. Moreover, because it is often unclear in advance that private market confidence will break down, pre-emptive action could lead to debt rescheduling that could have been avoided, unnecessarily tarnishing the country's credit standing. In short, the ad hoc and ex-post nature of financial rescue is not so much a symptom of failure in the international financial system as a necessary trait. Especially if weight is given to the problem of moral hazard, the ad hoc nature of recent rescue packages is a virtue, not a flaw.

59. It is useful to ask whether the appropriate institutions have been used in the process of financial rescue. They include the same institutions as in reschedulings of earlier years, although because the debt crisis of 1982-83 involved countries that have largely completed the transition from official development assistance to borrowing from private market sources, there has been a relatively lesser role for the Paris Club for the rescheduling of official debts. In contrast, there has been a new role for central banks and the BIS, and a qualitative change in the role of the IMF from merely financier to orchestrator of private lending.

60. The entry of central banks and the BIS into the process reflects the escalation of debt rescheduling from a minor phenomenon involving smaller countries to a problem for countries whose debts are large enough to have consequences for the entire financial system. The essential difference is that while the world economy could continue normal operations with minimal risk from financial disruptions in the cases of smaller countries (including Guyana, Jamaica, Nicaragua, Peru, Togo, Turkey and Zaire in 1978-80, it seemed unlikely to be able to do so in the cases of Argentina, Brazil, and Mexico, given their massive debts. With smaller countries, interim periods of disruption before a rescheduling meant the accumulation of minor arrears. But in the watershed case of Mexico, the systemic risks of allowing an unresolved suspension of payments to linger seemed too great to incur. Yet the past actors could not act quickly. Considerable time is required for IMF programmes to be designed and approved, and it takes time to mobilize new bank lending. The only institutions capable of immediate action were central banks, hitherto largely outside of the debt rescheduling process. Accordingly, the Mexican and Brazilian cases involved prompt "bridging" loans from central banks (with the European central banks acting through the BIS), to cover the periods between initial crisis and the completion of IMF-bank financing packages.

61. A consequence of this pattern was the emergence of a two-track system. For the debtors whose debts were large enough to have systemic impact, the machinery of financial rescue included immediate bridge loan capability by central banks of industrial countries. For other debtors, this vehicle generally was not available. Instead, bridge loans took the form of arrears. The difference even seemed to be institutionalized

by the enlargement of the General Arrangements to Borrow (GAB) in the IMF to create an emergency fund available in the event of a threat to the financial system. Because such a threat could be posed by a large country individually but by small countries only in the event of simultaneous disruption, this innovation seemed to imply further elaboration of the two-track system, with more machinery in place to deal with debt problems of the large debtors than with those of the small. 25/

62. On the basis of the experience through 1983, it is unclear to what extent a two-track approach -- one for large debtors, the other for small debtors -- is desirable or necessary. It is uncertain whether there is a special need for bridging loans of the type that have been provided by central banks and the Bank for International Settlements (BIS). These credits have been short-term, typically three to six months. They have been arranged within the space of days, without any policy preconditions on the country. They were probably necessary in the cases of Mexico and Brazil in 1982, to reassure the world financial community in the face of a totally new phenomenon of debt disruption for the largest debtors. However, as the cases of first Argentina and later Brazil have demonstrated, even a major country can go into arrears for a substantial period without provoking international financial collapse. Because net new lending is usually less than interest payments once the financial package is finally arranged, temporary arrears should provide an adequate vehicle for financing in the period preceding conclusion of a financial package. And the presence of arrears actually applies pressure on the country to come to terms with the IMF and the banks.

63. The past public image of the critical role of central bank lending probably has been exaggerated, in view of the short-term nature and limited contribution of this lending. The more important form for official support is through longer term lending by multilateral banks, the IMF, and national agencies. At the national level, the export credit agencies are promising vehicles for this purpose (if legislative inhibitions about their use for balance-of-payments support can be overcome), considering that bilateral concessional assistance is irrelevant for middle-income countries and in view of the political popularity of export credit. The United States Commodity Credit Corporation is another useful instrument. The basic judgement here is that there is relatively less need for the ultra-short-term bridge loans than their seeming prominence in past rescue packages would suggest, but greater need in the future for longer term official finance. This judgement also implies that there is no need for a new international agency or arrangement to provide bridging loans; and that instead it would be better to concentrate international efforts on the assurance of adequate funding for multilateral institutions that provide longer term lending.

64. More generally, the operational structure of financial rescue has probably been adequate and will inevitably, to some degree, appear ad hoc, considering the negotiated nature of reschedulings and the need to avoid moral hazard. Although an upper tier of machinery involving

central bank and BIS intervention appears to have emerged for the largest debtors, it seems unnecessary to extend this vehicle to smaller debtors, and indeed its real utility even for the larger debtors is doubtful now that the financial system has shown resilience even to arrears among the largest debtors. As for institutional participation, the process so far has involved the major relevant actors, and it is difficult to see what could be gained by incorporating other existing institutions or creating new ones to deal with debt problems.

#### B. IMF and bank involvement

65. The new role of the IMF in financial rescue warrants special attention. In the past, IMF standby agreements were viewed as a seal of approval that should facilitate the renewal of private capital inflows. In some cases, however, IMF programmes have been accompanied by private capital outflows or at least the absence of new inflows. 26/

66. In the cases of the major debtors, the resources of the IMF and other public agencies were too small relative to total borrowing needs for the rescue programmes to succeed unless private banks also extended net new financing. To ensure that they did, the IMF informed the banks that it could not provide lending unless they also provided new loans, and in addition rescheduled (or renewed) past loans coming due. This pressure played the useful role of mobilizing collective participation in a situation in which individual banks might otherwise have been unprepared to extend new loans in the fear that other banks would not bear their fair share. 27/

67. Subsequently the IMF repeated its role of insisting on new lending by banks even in smaller countries in debt difficulties, such as Peru in 1983. An additional factor reinforcing this orientation was the environment of criticism in the United States Congress that the IMF was bailing out the banks. By pointing to its new approach, the IMF could counter that it was bailing them in.

68. As long as lending to the distressed debtors remains on an involuntary basis (whereby banks without exposure find it too risky to lend but those with exposure lend modest additional amounts to safeguard their existing exposure), there will be a need for IMF leadership in mobilizing new bank lending. This role is necessary to help overcome the "free rider" problem, and to ratify the appropriateness of the amount of new lending requested; and the IMF's traditional role of certifying that the country's adjustment programme is viable will also continue to be essential in this environment.

69. Once the country returns to sufficient creditworthiness for lending to move to a voluntary basis, the IMF's role of pressuring the banks will no longer be appropriate. For longer term institutional purposes, the sooner the IMF can withdraw from an enforcement role with respect to bank lending, the better. The new arrangement strains the traditional



market relationships whereby private financial institutions take individual, voluntary actions under the limited regulation and support of, but not at the direction of, public entities.

70. The dynamics of financial rescue also raise questions about involvement of the private banks. A central question is whether the process of involuntary lending can be expected to continue long enough for the forces of international recovery and domestic adjustment to re-establish the basis for voluntary lending. In particular, will the smaller banks continue to co-operate in new lending?

71. Experience to date suggests that involuntary lending is a relatively robust mechanism. Thus, Brazil was successful in late 1983 in raising almost all of its \$6.5 billion in new lending, a year after its initial round of involuntary lending. The mobilizing role of the IMF is one factor. Another would appear to be that the smaller banks are well aware that their non-participation would amount to benefiting at the expense of larger banks, and the larger banks have successfully appealed to the argument of fair sharing of the burden. More fundamentally, however, it is the unattractive alternative that encourages all banks to participate in new lending. That alternative would very probably be a shift to unilateral enforcement of new lending through capitalization of interest by the country. That is, a widespread erosion of bank participation in new involuntary lending would tend to lead, conceivably even at the request of some of the larger banks, to direct capitalization (rescheduling) of some of the interest rather than full payment of interest and receipt of new lending. Under interest capitalization, the smaller banks would no longer have the option of avoiding new lending. As discussed below, capitalization of interest would be a significant deterioration in the process of debt management.

72. A related issue is whether the process of financial rescue has given the banks a moral claim on the governments and central banks of industrial countries. Are banks that provide new, risky loans in these circumstances entitled to special support by their monetary authorities in the event of future losses? Here the concept of the present discounted value of exposure is useful. Because the banks have been expanding exposure at a rate below the interest rate, while continuing to be paid interest due, they have in fact been gradually withdrawing in a meaningful economic sense. <sup>28/</sup> They therefore have little claim that the public has forced them to increase their (economically meaningful) exposure and that they deserve special future support.

73. As a matter of practice, while there is some reason to believe that in the cases of the loans of certain continental banks to certain East European countries, there has been a perception by banks that because they were lending at the government's request they had obtained a certain claim to government support, there is little evidence that more generally and with respect to loans to developing countries such a perception exists among banks.



74. This issue is related to the question of risk spreads. If banks were gradually accumulating greater political claims on central banks and governments because of their participation in international financial rescue, they might have less basis for raising lending spreads on grounds of increased risk. But there is little reason to believe that banks have in fact accumulated such claims, or believe that they have. Because any such claims would be ultimately political, and because the banks have faced a rather hostile political environment domestically (at least in the United States, where numerous punitive amendments were attached to early versions of the legislation increasing IMF quotas), the banks have little reason to believe they are building up credit for special treatment in the future.

75. Another institutional issue concerning the banks involves the relationship of their lending disbursements to those of the IMF. Because bank disbursements have been tied to IMF disbursements, delays have occurred in actual disbursement of loans committed by the banks. Thus, when an interim IMF evaluation finds non-compliance and triggers suspension of drawdowns, a hiatus occurs during which bank disbursements themselves are suspended. Because it automatically requires several weeks or even months to obtain approval by the IMF Executive Board for reinstatement once a programme is suspended, even if corrective country action is prompt, there can be unnecessary delay in bank disbursements. This delay can put the banks themselves in an awkward position, as their loans approach non-performing status after 90 days (because they have not disbursed the funds the country needs to make interest payments). A preferable arrangement would be to make bank disbursements independent of IMF programme status, with the exception that bank disbursements would be suspended upon the positive recommendation of the Managing Director of the IMF to do so.

### C. Costs of rescheduling

76. One of the most controversial aspects of financial rescue has been the increases in lending rates and fees associated with rescheduled loans. Although the underlying level of international interest rates fell from approximately 16 per cent (London interbank offer rate, LIBOR) in mid-1982 to 10 per cent in mid-1983, interest charges on rescheduled debt have not declined as much. Special rescheduling costs have included a shift of the base rate from LIBOR to United States prime rate, typically about 3/4 per cent point above LIBOR; an increase in the spread above LIBOR; and additional refinancing fees. 29/

77. The additional cost has been greatest for Mexico, because its spread went from one of the lowest to a higher rate associated with rescheduling, and because Mexico has formally rescheduled a high proportion of its debt. Specifically, on \$19.5 billion public debt rescheduled, Mexico is paying a spread of 1 3/4 per cent above prime, equivalent to about 2 1/2 per cent above LIBOR. In contrast, the average spread on its new Eurocurrency credits in 1978-80 was 0.91 per cent above LIBOR. 30/ Accordingly, the effective increase in spread above LIBOR was 1.6 per cent. Applying this increment to the amount

rescheduled (including \$15 billion loans to the private sector), Mexico is paying \$560 million annually in additional interest charges on rescheduled debt. In addition it paid a rescheduling fee of 1 per cent, or \$195 million on public loans rescheduled (and another \$150 million on private, assuming comparable terms). Amortizing the fee over the eight-year rescheduling maturity, the fee added another \$43 million in annual costs. Finally, on its new borrowing of \$5 billion in 1983, Mexico paid a spread of 2 1/8 per cent above United States prime -- comparable to 2 7/8 per cent above LIBOR, or 2 percentage points above its 1978-80 average, for an extra cost of \$100 million annually. Altogether Mexico is paying approximately \$700 million extra or 1.75 per cent on the amount of principal involved and approximately 8 per cent of its 1983 import bill.

78. An obvious question for reform of the process of financial rescue is whether lower additional rescheduling interest spreads and fees could be obtained. Higher spreads and fees help insure bank co-operation in rescheduling and participation in new financing, and contribute a much greater proportionate increase to bank profits than to borrower costs (because the banks themselves are operating on borrowed money and their profit is only the spread above the cost of money, while the cost to the borrower is the full interest rate). 31/ And some rescheduling penalty is appropriate because moral hazard exists if rescheduling is costless.

79. To a considerable degree, however, the rescheduling spread is a matter of arbitrary, negotiated outcome. The credit market is not being cleared by a free pricing mechanism; indeed, a property of credit market is that an exceptionally high interest rate fails to clear the market because it becomes evidence itself of unreliability of the borrower. In a rescheduling situation, lenders tend to be locked in; and they also have limited alternatives to participating in some new lending because not doing so would jeopardize their outstanding principal. To be sure, an acceptable interest rate on new lending is important in coaxing the smaller, "free rider" banks (who view their own actions as too small to affect the outcome) to participate.

80. In these circumstances, analogously to the determination of wages in the market structure of "bilateral monopoly" between a larger firm and organized labour, the somewhat arbitrary price will have to be within a range that both sides consider to be fair. From the bank's standpoint, it will not be fair to leave interest rates unchanged from the original terms (and to do so constitutes moral hazard). From the country's standpoint, a large rise in interest rates just when the crisis is most severe will seem unfair.

81. Considering all of these factors, and taking account of political pressure for lower interest charges both in borrowing countries and in the United States Congress, a workable rule of thumb might be that rescheduled loans would bear interest rates with spreads above LIBOR (the same base as before -- not United States prime) at perhaps 1/2 per cent point higher than in the original loan agreement. Interest spreads on new lending would be similar or perhaps modestly higher to encourage small bank participation.

82. In late 1983 the banks were moving in the direction of lower spreads. For Brazil's new borrowing of \$6.5 billion, they lowered the spread above prime by a token 1/8 per cent (from 2 1/2 to 2 3/8). In Mexico, however, on new borrowing of \$3.8 billion for 1984 they lowered the spread sharply, from the 1983 spread of 2 1/8 above prime to only 1 1/8 per cent above prime. <sup>32/</sup> This rate would still be about 1 percentage point above the 1978-80 average (because prime is higher than LIBOR), but is much closer to the modest incremental spread suggested here. The banks justified the reduction in spread on the grounds of Mexico's sharp improvement in external accounts, and the resulting reduction in risk. However, the banks also reportedly faced pressure from the United States Federal Reserve to lower spreads, including those on the reschedulings already negotiated.

83. In sum, there appears to be room for moderation in the spreads charged to countries undergoing financial rescue. But the eventual spreads should still exceed those on the original loans, or else there will be no reward to those countries making efforts to service their debt without disruption. Moreover, the potential savings to debtor countries should not be exaggerated. Trimming the additional spreads from the range of 1.6 percentage points (the Mexican case) to only one-half percentage point would save approximately 1 per cent on the debt affected. In the Mexican case, if all the formerly rescheduled debt were renegotiated (a possibly destabilizing incident), the savings would be about \$400 million annually, or about 3 per cent of a more normal year's import value. It is unlikely that this saving would permit a significant rise in the domestic growth rate (at most perhaps one extra percentage point for one year). And for most countries, the savings would be much less than for Mexico, as noted earlier. In short, trimming interest charges could help debtor countries, but only marginally. Of course, reducing interest rates below LIBOR would provide much more relief; this more extreme option ("interest forgiveness") is discussed below. <sup>33/</sup>

#### D. Magnitude of financing

84. The amounts of debt rescheduling have varied significantly from case to case. The amounts of new net lending have varied somewhat less, typically ranging from 7 to 12 per cent of existing exposure for banks and new public financial support somewhat smaller than that from the banks. The question arises as to whether there is some optimal, or at least appropriate, amount of rescheduling that balances the borrower's needs with lender willingness.

85. The amount of rescheduling is less variable than appearances might suggest. It is determined by two principal factors; the number of years covered, and whether short-term debt is included or excluded. At one extreme, at first Brazil rescheduled only one year's long-term principal; at the other, Mexico rescheduled two years of principal including short-term. It would be misleading, however, to conclude that Mexico achieved a much more favourable bargain.



86. Rescheduling over at least two years, as in Mexico, would appear preferable to a single-year rescheduling. Reliance on voluntary maintenance of short-term credits is a source of vulnerability for interbank deposits, as shown by the Brazilian case, and is less effective in a country with a more severe underlying debt burden, as shown by the problems of Brazil compared with the relative success of Yugoslavia. However, it remains an open question whether rescheduling all of short-term debt is desirable. Doing so tends to create a later bulge in long-term amortization (Argentina, Mexico) and it could be preferable to identify a level of hard-core trade finance -- perhaps half of one year's imports -- and maintain at least this much short-term debt without rescheduling.

87. A more significant question concerns the amount of net new financing, considering that past loans will tend to be either formally rescheduled or informally renewed. In both the Mexican and Brazilian cases, the amount of new financing was determined, with advice from the IMF and the banks, on a basis of what the markets would bear and how much adjustment was feasible. In 1983 Mexico's actual adjustment far exceeded what had been thought possible, while Brazil's experience suggested that an unrealistic limit had been set on new financing based on the presumption of extremely scarce financing.

88. In practice the amount of net new financing is unlikely to be able to exceed an expansion of bank exposure by a rate equal to the interest rate, under conditions of debt-servicing difficulties. Increased bank lending at rates in excess of 20 per cent annually, as in the 1970s, is not an alternative under credit market conditions since the debt crisis. However, if a bank expands its exposure by anything less than the interest rate, it is actually reducing the present discounted value of its exposure over time and gradually "digging itself out" instead of "digging itself in deeper." (This point has been missed by the conservative critics of IMF support who argue that it induces still more bank lending and a larger potential final loss.)

89. The optimal amount of new financing, then, will have limits set by bank exposure (most optimistically growing at the interest rate) and by plausible magnitudes of official support. Against this availability, the country's import needs for growth must be considered. It will generally be difficult for the country to cut back imports by more than three or four times the percentage rate deceleration in growth. That is, it may require one percentage point growth cutback to reduce imports by three per cent. 34/ Ideally rescue packages would be designed to avoid actual declines in per capita income (or, growth rates of at least 2 per cent or more). The appropriate amount of net new financing would then be identified at some point within these limits from the sides of demand for and supply of credit. 35/

90. In practice, although governments and international agencies could usefully develop analyses along these lines to identify appropriate amounts of net new lending, there will still be limitations set by creditor willingness, and these limits may not even permit expansion of



exposure at the interest rate. If not, either official lending will have to increase or the country's political limits may have to be tested by an interim period of extremely low or negative growth rates.

91. One recent argument concerning the amount, duration, and cost of relief is that international arrangements should consider the precedent of domestic bankruptcy proceedings, whereby the terms of restructuring are set at levels that offer prospects for success and for avoidance of subsequent repeated restructuring. 36/ However, if the debt problem of developing countries is generally one of illiquidity and not insolvency, as suggested above, analogies from domestic bankruptcy may be of limited relevance. Moreover, there are some fundamental differences between domestic and international debt disruptions. In domestic lending, creditors have tangible collateral they can seize. In foreign lending the creditor relies upon sovereign integrity rather than tangible collateral. Correspondingly, while domestic bankruptcy statutes may play a positive role in avoiding the stripping of machinery and equipment by over-arduous creditors, there is no comparable ease of excessive demands by creditors in international lending.

92. The principle that reschedulings should be viable and not induce repeated non-performance on the terms is of course important in its own right, without adducing the analogy of domestic bankruptcy. In practice, the issue has become one of whether to reschedule one, two, or more years of principal due. Experience in the major rescue efforts suggests that rescheduling of two or even three years principal is more desirable than a one-year rescheduling, which has had to be followed by a second year's rescheduling when tried in Argentina and Brazil. However, much longer reschedulings would not only unduly dilute creditor influence but also perhaps unnecessarily reschedule amounts that could be paid on a timely basis after adjustment and improved international circumstances, unnecessarily eroding the country's credit rating. As for appropriate amounts of net new lending (with respect to the same issue of viability), the general outlines just set forth would seem to limit the options -- unless the case deteriorates significantly and more serious contingency approaches become necessary (as discussed below).

#### IV. Alternative Strategies

93. The experience to date suggests that the existing strategy of international financial rescue is accomplishing acceptable results and should continue to do so if the international economy achieves reasonable recovery. Perhaps the most impressive success has been in Mexico. I have examined elsewhere the family of proposals for more radical reform of international debt, and the difficulties they would involve. 37/ A prototype of fundamental reform would transfer bank claims from debtor countries to new international agencies at some loss on face value, reduce interest rates, and greatly lengthen maturities of the debt. The central drawbacks with such schemes are their requirement for large amounts of public capital, their seeming misdiagnosis of an illiquidity problem as an insolvency problem, and their adverse effect of choking off new capital flows (by ending the incentive mechanism of

involuntary lending once banks are let off the hook through the transfer of their claims on countries to an international agency).

A. Interest capitalization and forgiveness

94. Because the sweeping reform schemes seem counterproductive, a case-by-case policy is the best course for dealing with the debt problem. But in some individual cases the problem could become so intractable that new lending combined with full interest payment is unviable. It appears likely that, in such circumstances, the next step in the sequence of deteriorating debt-servicing would be some form of interest capitalization.

95. If a country is unable to meet interest payments in view of the maximum possible amount of new lending that can be mobilized, a rescheduling agreement could reschedule some interest as well as principal. There are some advantages, but more serious disadvantages, to this approach.

96. The advantage of interest capitalization, or interest rescheduling, is that it forces participation by all existing bank lenders on a proportionate basis. Banks are merely informed that, although no new money will be requested of them, only a fraction of the interest due will be paid and the remainder to be accrued as an increase to the principal outstanding on the loan. The free rider problem vanishes, because no bank is given the option of non-participation.

97. This benefit comes at a high price, however. There is a mechanical difficulty in terms of regulation. A new loan combined with use of the funds toward full payment of interest on old loans means that both loans are viewed as legally valid, performing loans. But the same economic effect accomplished by absence of new lending coupled with capitalization (instead of payment) of some of the interest on old loans could make the loans "non-performing" or "value-impaired" under current regulatory practice (unless such capitalization convincingly did not reduce, or even improve, ultimate collectability, and restructuring were on market-related terms). Sizeable reserves against loss must be set aside on such loans. For countries such as Argentina and Brazil, the magnitude of such reserves would be devastating to bank profits.

98. Suppose, however, that regulators revised their practices and facilitated interest capitalization on sovereign loans, perhaps at the price of setting aside much more modest loss reserves than on other non-performing loans, and perhaps through applying lenient judgement on the ultimate collectability of sovereign loans with interest capitalized. There would still be serious disadvantages to interest capitalization. One disadvantage is that it would tend to eliminate the last element of voluntariness remaining in the current environment of involuntary lending. Under the present process, the country must present a sufficiently convincing economic programme that banks are prepared to make new loans in the amount agreed upon among the country,

bank representatives, and the IMF. Under interest capitalization, however, the country would almost certainly gravitate toward a more unilateral posture of merely informing the banks of the interest being capitalized, with much less need to prepare a convincing programme of economic policies.

99. The other, potentially even more serious, disadvantage with interest capitalization is that it would tend to induce the country to build up debt much more rapidly than otherwise, thereby postponing (perhaps indefinitely) the day of return to creditworthiness. Consider the case of Brazil. Suppose that Brazil negotiated a five-year grace period on all interest and principal, and that during this period its interest obligations were accrued (capitalized). <sup>38/</sup> This procedure would eliminate annual interest payments of approximately \$10 billion over five years.

100. Assuming that, beginning in 1984, Brazil used the savings of \$10 billion annually to purchase more imports rather than build up reserves (and the scheme makes little sense if its use is not to increase imports to speed domestic growth), by 1988 Brazil's external debt would amount to approximately \$50 billion more than otherwise (or \$153 billion instead of approximately \$103 billion estimated in the projection model discussed above). <sup>39/</sup> (Although extra debt build-up would be less than the full \$10 billion in 1984, when under the past approach there would be additional new lending, extra debt would be greater later because of interest on the additional debt being accumulated). The ratio of net debt to exports of goods and services would correspondingly only fall from 382 per cent in 1982 to 303 per cent in 1988, instead of 198 per cent as in the projections of this study. Based on past statistical features of creditworthiness, the revised 1988 ratio of debt to exports would probably be above the critical threshold associated with debt rescheduling. Instead of regaining creditworthiness by 1986, Brazil would remain uncreditworthy into the more distant future. Such an extreme result should be avoided if at all possible.

101. In the case of interest forgiveness, the problems are of a considerably different nature. Under interest forgiveness, past loans would have interest rates reduced from (for example) LIBOR plus 1 1/2 per cent to a flat 5 per cent (or perhaps LIBOR minus 5 per cent, currently about the same rate). For the debtor the short-run effect would be unambiguously better -- if agreement could be reached. A unilateral attempt at such an extreme measure would probably be counterproductive, as short-term trade credit would dry up and foreign seizures of export shipments might occur. Over the longer run, this type of debt forgiveness could well be unfavourable even for the debtor. It would be highly likely to freeze the country out of any new lending for many years. For the debtor it would make sense only if the amount of new lending were expected to be far below interest payments due over a decade or more.

102. Specifically, let  $B_t$  be the new borrowing the country might expect to mobilize in year  $t$  under existing rules of the game. Let  $B_t$



be the amount it could expect after having shifted to a regime of interest forgiveness. Let "a" be the ratio of the revised, concessional interest rate to the rate the country would otherwise pay. Let  $r^*_t$  be the scarcity premium (shadow price) to the country on foreign exchange in year  $t$ , representing the net economic benefit to the country of an additional dollar of foreign exchange. Then for the debtor country the benefit ( $W$ ) of shifting to a regime of interest forgiveness over a period of  $N$  years would be:

$$W = \sum_{t=1, N} \frac{r^*_t [D_0(a i_t) - (B_t - B'_t)]}{(1+d)^t}$$

where  $D_0$  is outstanding debt,  $i_t$  is the market interest rate in year  $t$ , and  $d$  is the country's time discount rate. The term  $D_0(a i_t)$  is the annual gross foreign exchange savings from interest relief. The term  $B_t - B'_t$  is the annual loss of new loans caused by the strategy. It is this term that shows the adverse side effect of the strategy, substantially reducing the gross benefit from interest forgiveness.

103. For Brazil, for example, new lending might average \$4 billion annually over a decade under the present strategy, but fall to zero under interest relief ( $B_t - B'_t = \$4$  billion). With a base of approximately \$80 billion in relevant debt, cutting the average interest rate from 10 per cent to 5 per cent would save Brazil \$4 billion per year -- just offsetting the loss in new lending. Thus the size of the interest relief factor would have to be large ("a" much closer to unity) to leave the debtor country better off. In a word, authorities in the country seeking interest relief had better be certain that prospects for new lending are extremely bleak for a long period, or else they will make the country worse off by trading new borrowing away for relief on past borrowing.

104. For the creditor, the loss from interest relief is unambiguous. Significant interest relief would cut the present value of the loan asset by large proportions. For example, on a present discounted value basis, a seven-year loan with its interest rate cut from 11 per cent to 5.5 per cent would lose 30 per cent of its value; eliminating all interest but repaying principal in 7 years would eliminate half of the loan's present value. Considering that large banks have loans outstanding to developing countries and Eastern Europe equal to nearly 300 per cent of their capital, the loss of one-third to one-half of the value of these loans through widespread concessional interest relief would cause generalized insolvency to much of the Western banking system.

105. Interest forgiveness would also involve real transfers to debtors. On any large scale, interest forgiveness would mean losses that more than exhaust shareholder equity in the banks. The losers would have to include the public beyond shareholders. Uninsured depositors would be one losing class, and the general public could be another, as taxpayers financed the outlays of



government deposit insurance programmes. Even if direct losses could be confined to bank shareholders (and as discussed above, widespread cuts of interest from LIBOR to say 5 per cent would approximately exhaust bank capital and shareholder equity), there could be large indirect losses to the rest of the public from the shock effects on domestic economic activity as the result of virtual bankruptcy of the banking system.

106. Another dimension of the transfer issue is that by conferring interest forgiveness, the public and bank shareholders of industrial countries would be transferring a grant of resources to the debtor countries. Yet the major debtor countries are not countries that are usually eligible for concessional grants. They are middle-income countries. There would be no corresponding transfer to low-income countries in Africa and Asia that have never borrowed heavily from the banks.

107. Considering that even middle-income countries have much lower living standards than the industrial countries, however, and because the debtors are often governments (whose marginal expenditures may tend to be for programmes affecting low-income groups) while the creditors in the first instance are stockholders of banks in industrial countries, concessional interest rate changes would tend to be progressive in distributional terms even though the low-income countries would not participate. The reason for avoiding concessional interest rate renegotiation is not one of equity, but one of pragmatic consequences. The basic risk is that such changes on a widespread basis could cause such general dislocation to the world economy, and such a collapse in the country's long-term creditworthiness, that the ultimate consequences would be adverse even to the borrowers themselves.

108. An equity argument sometimes made is that world interest rates have become "usurious" because of policy distortions in the North, not the South, and that accordingly some reduction in interest rates on outstanding loans would be equitable. This argument does not take into account the favourable transfer to debtors during the period in the 1970s when real interest rates were negative; however, even here the equity aspects are ambiguous because it might be argued that borrowing countries were induced by the low rates to take on more debt than they could safely manage.

109. As discussed above, there is a tension between the economic case for higher interest rate premiums to help mobilize additional lending in cases of debt-servicing difficulties and the political perception of the inequity of these increases. Keeping this trade-off in mind, and in view of the various equity issues just reviewed, on balance the best approach would appear to be the negotiation of lower spreads above LIBOR, especially where significant recovery toward creditworthiness can be shown, but only back to levels of spreads modestly above those on the original loans before rescheduling. To adopt still lower spreads, and especially to negotiate interest rates below LIBOR, would almost certainly do long-term damage to creditor confidence in a country, whereas the squeezing of spreads back to more normal levels would be unlikely to do so.

110. In sum, interest capitalization is an undesirable second-best strategy that should be avoided except in extreme circumstances, because its

disadvantages of unilateralism and more rapid build-up of debt outweigh its advantage of overcoming the free rider problem. The more extreme measure of outright interest relief would be seriously damaging to the banks and under plausible circumstances detrimental to the debtor country itself because of the resulting freeze in future borrowing.

## V. Conclusion

111. The central policy implication of this study is that the approach of case-by-case international financial rescue on market-related terms, the broad strategy applied since the debt crises erupted in mid-1983, is the best approach to the debt problem and should be continued. This strategy has already accomplished remarkable adjustment in Mexico and sustained other hard-pressed countries such as Argentina and Brazil, even if with considerable snags. The arrival of global economic recovery should validate this process of temporary lending to overcome illiquidity, by raising exports and returning creditworthiness to more normal conditions. The calculations presented here indicate that, despite considerable maturity bunching in the late 1980s in Argentina and Mexico as the result of long-term rescheduling of short-term debt, this process of return to creditworthiness should also make feasible the return to normal, voluntary lending, even if the larger banks have to finance the phased withdrawal of smaller banks. If political breakdown prevents the realization of this scenario, however, or if the world economy falls again into serious recession, governments and banks may need to adopt contingency measures on a case-by-case basis, possibly including otherwise undesirable capitalization of interest.

112. The institutions and procedures involved in financial rescue to date have been broadly appropriate. It would be difficult to establish more automatic mechanisms without introducing moral hazard. The principal actors to date -- the borrower countries, central banks and governments of lending countries, the banks, and the IMF -- have been the appropriate ones. The historically new role of the IMF in mobilizing new lending has been important and successful. Seeming disparities in amounts of relief exaggerate real differences (as in the ambiguous choice between rescheduling short-term debt or maintaining it at a core level).

113. The most likely area for improvement in the process of financial rescue is in the reduction of additional interest rate charges for rescheduling and new lending. To a considerable degree these extra charges are arbitrary rather than market-clearing, and they need to be determined on a basis that appears fair to both lenders and borrowers. It might be possible to meet these criteria by increasing spreads only by about 1/2 per cent above the original spreads on the loans, far less than the increases in spreads experienced in 1982-83 (caused in part because of redesignation on the basis of the United States prime rate). Such reductions would ideally be linked to demonstrated improvement in the country's creditworthiness, as in the case of Mexico's proposed terms for new lending in 1984; otherwise, the smaller banks especially could be more resistant to new lending.

## FOOTNOTES

1. William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, Washington, D.C. Referred to hereafter as PA4.
2. Ibid. pp. 13, 35, 131.
3. Ibid., pp. 10, 35.
4. Ibid., p. 25.
5. William R. Cline, International Debt: Systemic Risk and Policy Response (Washington, D.C.: Institute for International Economics, 1984), Appendix C.
6. Naciones Unidas, Comisión Económica para América Latina, Balance Preliminar de la Economía Latinoamericana durante 1983 (Santiago, Chile: CEPAL, December 1983), cuadro 7. Referred to hereafter as CEPAL, Balance Preliminar.
7. M.S. Mendelsohn, Commercial Banks and the Restructuring of Cross-border Debt (New York: Group of Thirty, 1983), pp. 20-33.
8. See Edmar Bacha, "The IMF and Prospects for Adjustment in Brazil", in John Williamson, editor, Prospects for Adjustment in Argentina, Brazil, and Mexico: Responding to the Debt Crisis (Washington, D.C.: Institute for International Economics, June 1983), pp. 31-41.
9. Jeremy Morgan, "Argentina Moves Toward Short-Term Agreement", Journal of Commerce, 22 October 1982; Caroline Atkinson and James L. Rowe, Jr., "Two Nations Agree to IMF Terms", Washington Post, 11 November 1982, p. D11.
10. PA.4.
11. CEPAL, Balance Preliminar, cuadro 2.
12. Fundacao Centro de Estudos do Comercio Exterior, Balanca Comercial e Outros Indicadores Conjunturais, Setembro 1983, and O Globo, 6 October 1983, p. 21.
13. CEPAL, Balance Preliminar, cuadros 2, 3, 5.
14. Anne O. Krueger, "Interactions between Inflation and Trade Regime Objectives in Stabilization Programs," in William R. Cline and Sidney Weintraub, eds., Economic Stabilization in Developing Countries (Washington, D.C.: Brookings Institution, 1981), pp. 83-118.
15. PA4.

16. The relationship is:

$$g_m = -3 + 3g_{\text{OECD}}$$

where  $g_m$  is the percentage growth of real non-oil imports from developing countries and  $g_{\text{OECD}}$  is the OECD growth rate. See William R. Cline, Trade Policy in the 1980s (Washington, D.C.: Institute for International Economics, 1983).

17. John Williamson, The Exchange Rate System, POLICY ANALYSES IN INTERNATIONAL ECONOMICS No. 5, Institute for International Economics, Washington, D.C., September 1983.
18. Thus, for the 7 largest debtors, the projection model estimated the following 1983 current account balances: Argentina, -\$2.5 billion; Brazil, -\$7.1 billion; Mexico, -\$2.3 billion; Republic of Korea, -\$1.7 billion; Venezuela, -\$4.4 billion; Philippines, -\$4.1 billion; and Indonesia, -\$4.6 billion; for a total of -\$26.7 billion. On the basis of actual 1983 performance (for the Latin American countries), or performance through the first half of 1983 (for others), 1983 current account balances were: Argentina, -\$1.9 billion; Brazil, -\$7.7 billion; Mexico, +\$3.7 billion; Republic of Korea, -\$1.7 billion; Venezuela, +\$5 billion; Philippines, -\$4.3 billion; and Indonesia, -\$3.4 billion; for a total of -\$10.3 billion, an aggregate deficit only 39 per cent as large as in the original 1983 projections. Based on IMF, International Financial Statistics, October 1983, OECD, Monthly Statistics of Foreign Trade, September 1983, and national sources.
19. For a discussion of involuntary lending and the free rider problem, see PA4.
20. William R. Cline, "A Logit Model of Debt Rescheduling, 1967-1982", in International Debt: Systemic Risk and Policy Response (Washington, D.C.: Institute for International Economics, 1984), Appendix A.
21. An analysis of the issues of maturity bunching and the return to voluntary lending appears in William R. Cline, International Debt: Systemic Risk and Policy Response (Washington, D.C.: Institute for International Economics, forthcoming), chapter 5.
22. New York Times, 31 December 1983.
23. William R. Cline, International Debt: Systemic Risk and Policy Response, chapter 5.
24. I am indebted to Sidney Dell for formulating some of the issues examined here.
25. To be sure, monetary authorities have maintained ambiguity about the conditions under which the enlarged GAB might be used.
26. As in Peru in 1978. William R. Cline, "Economic Stabilization in Peru, 1975-1978", in William R. Cline and Sidney Weintraub, Economic Stabilization in Developing Countries (Washington, D.C., 1978), p. 309.



27. Technically, each bank's new lending conferred an external economy on other banks by helping shore-up the existing debt. If other banks did not similarly make new loans, they would benefit at the expense of those that did. Through centralized leadership by the IMF it was possible to internalize, for the banks as a group, these externalities.
28. To maintain an exposure of \$100 million at 1983 present discounted value and with a 10 per cent interest rate, a bank would have to lend \$10 million new if it were paid \$10 million interest, leaving exposure of \$110 million in the second year, \$120 million the third year, and so forth. If instead it lends only \$5 million in new funds annually while receiving \$10 million in interest, it is successively reducing the present discounted value of its exposure below the 1983 level (even though the face value of exposure rises to \$105 million, \$110 million, and so forth).
29. Pedro-Pablo Kuczynski, "Latin American Debt: Act Two", Foreign Affairs, Autumn 1983, p. 24.
30. M.S. Mendelsohn, Commercial Banks and the Restructuring of Cross-border Debt, (New York: Group of Thirty, 1983), p. 24; and World Bank Annual Report, 1980, p. 148.
31. PA4, p.83.
32. Washington Post, 27 December 1983; New York Times, 31 December 1983; Washington Post, 30 December 1983; Wall Street Journal, 4 January 1984.
33. As a final note on interest costs, it may be asked whether there is some optimal interest rate that will encourage the country to enter into appropriate agreements. This issue is raised by the experience of one relatively large Latin American debtor country which in 1983 accumulated arrears rather than conclude a rescheduling, thereby saving significant additional interest costs. However, because this country had relatively large reserves and, through sharp restrictions on imports, no current account deficit requiring new lending, it was in an unusual position. Its experience suggests not a general conclusion that interest charges should be lower to encourage countries to negotiate, but rather that countries in stronger positions may be able to hold out for better deals.
34. For Brazil, regression of real imports on the real GDP growth, current and lagged one year, and on the real exchange rate yields an income elasticity of approximately 3 for 1964-82 data.
35. Judged on this basis the Brazilian programme in 1983 was too parsimonious. Imports declined by 18 per cent, suggesting the need for a sharp GDP cut (which indeed occurred) even allowing for the effect of a large exchange rate depreciation. At the same time, the net increase in bank exposure was well below the interest rate (which at 10 per cent, for LIBOR, would have yielded increased exposure of about \$6 billion). That is, the initial increase was set at only \$4.4 billion; even this amount was not met as short-term credits declined; and the \$6.5 billion additional funding by late 1983 was to cover 1984 as well as the rest of 1983.

36. Sidney Dell, "The International Monetary System: Notes on Selected Aspects of Institutional Reform", Istanbul Roundtable, 29 August - 1 September, 1983.
37. PA4.
38. Professor Rüdiger Dornbusch of MIT has proposed a programme along these lines for Brazil. His approach would involve a sharp devaluation, an incomes policy, and avoidance of further reductions in budget deficits. Rüdiger Dornbusch, presented at a seminar held by Corporacion de Investigaciones Economicas para Latinoamerica, Santiago, Chile, 24 October 1983.
39. William R. Cline, International Debt: Systemic Risk and Policy Response, Chapter 8.



## THE WORLD DEBT PROBLEM

Rudiger Dornbusch and Stanley Fischer\*

Introduction

In 1983 the debt problem of developing countries, especially those of Latin America, appeared on the way to a solution. Despite the strains following first the Polish and then the major Latin American borrower difficulties, the international financial system did not collapse. Moratoria quickly gave way to IMF adjustment programmes and debt rescheduling, providing the debtors with a means of avoiding default and meeting debt-service liabilities by borrowing fresh money from the banking system.

The present "muddling through" strategy is becoming increasingly doubtful as high world interest rates force massive additional transfers from debtors to creditors, at the cost of deep recession in the adjusting countries. There is much discussion as to whether the debt crisis is a liquidity or a solvency problem. But the definition of solvency for a nation is not as clear-cut as that for a corporation: given the existing sizes of debts, living standards in debtor countries could be depressed to levels so low as to make it possible to pay off the debts. The real issue is whether their political systems and citizens can and should be made to stand the strain.

A broad front of opinion has called for change. Martin Feldstein (1984) has presented the case for a new approach as follows:

"But the time has surely come to go beyond high-risk crisis management. The debtor nations need new longer-term financial arrangements that embody explicit safeguards against destabilizing changes in world financial markets. Within such a financial framework, the debtor nations and their industrial trading partners can take the steps necessary to promote the increased exports that can provide the basis for long-term growth and financial independence."

Lord Lever (1984) in calling for new alternatives has argued:

"... we must not attempt to maintain the pretense that purely commercial lending is adequate for our purposes. It is defective in that it requires premature attempts at balance-of-payments

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surplus by the debtor countries not compatible with our political interests or theirs. Recent net transfers of resources from the debtors have been bought at the cost of economic slack and grave risk to political stability. They are too small to restore confidence but large enough to do serious damage to the debtors' economies and societies: they are neither desirable nor sustainable."

This paper reviews the debt problem and the already extensive literature on the subject from a broad perspective. After setting out an analytical framework we present a brief historical analysis of the present debt crisis. From there we proceed to an evaluation of various debt scenarios that have appeared since last year, and then to our own evaluation of the sustainability of the "muddling through" process. The paper concludes with an evaluation of alternative proposals, in particular the idea of interest rate caps and interest rate capitalization. We also discuss the need for and the difficulties of a strategy of export-led growth in developing countries (DCs). Such a strategy, we argue, is essential in view of the prospective drying up of net lending to DCs.

### I. Debt dynamics

In this section we set out a framework for the discussion of debt history and proposed solutions. The dynamics of the debt problem are analyzed starting from the debt accumulation equation: 1/

$$(1) \quad D_t = (1 + i_t)D_{t-1} - NX_t$$

where  $D$  is the dollar value of outstanding debt  
 $i$  is the nominal interest rate on the outstanding debt  
 $NX$  is the non-interest component (measured in dollars) of the current account or the "resource gap".

The ratio of debt to exports is the most widely used indicator of a country's external debt position. Transforming (1) into an equation for the debt-export ratio,  $d$  (with exports measured in dollars):

$$(2) \quad d_t = K_t d_{t-1} - nx_t$$

$$K_t = (1+i_t)/(1+gx_t)$$

where  $gx$  is the nominal (dollar) growth rate of exports and  $nx$  is the ratio of  $NX$  to exports, or the resource gap measured as a fraction of exports.

The debt-export ratio is analogous to the debt-income ratio used as a measure of debt-capacity for individuals, or the debt-GNP ratio used in discussing fiscal policy. It suffers obvious shortcomings as an indicator of a country's foreign debt situation: as a measure of debt burden it would be preferable to have the real interest bill, perhaps

relative to GNP; as a measure of liquidity needs, the debt-service-to-export ratio might be preferable; as a measure of the vulnerability of an economy to a cutoff of lending, it would be preferable to have in the denominator a variable representing the economy's potential net earnings of foreign currency, for a cutoff of foreign capital would, by reducing imports, reduce exports as well; as a measure at a moment of time it neglects future developments that would affect a country's ability to pay its debts. 2/ But the debt-export ratio serves well as an indicator of the viability of projected paths of the balance of payments. Any forecast with an ever-increasing debt-export ratio describes a situation that is not viable.

In some instances a transitorily rising debt-export ratio may be entirely consistent with an improvement of a country's ability to service its external debt. For instance, to the extent that debt accumulation in the development context has as a counterpart investment and future export earnings, rising debt-export ratios are a leading indicator of prosperity, not catastrophe. Unfortunately, it cannot be argued that debt accumulation has in fact been predominantly financing investment that was productive by the test of net dollar earnings (as opposed to useful, desirable, socially justified etc.), at least not in the late 1970s.

Equation (2) points to the four key determinants of the debt-export ratio. Assuming a positive outstanding stock of debt, the debt-export ratio at the end of period  $t$  is higher the higher the nominal interest rate, and the higher the inherited debt-export ratio; a high growth rate of the value of exports, or a positive non-interest current account, tend to reduce the ratio. The analysis of the history of the debt problem of the 1980s to be presented in Section II is summarized by equation (2). Borrowing during the seventies had made accumulated debt,  $d_{t-1}$  large. The second oil shock and over-valued exchange rates made net exports,  $nx$ , negative. The increase in the interest rate, followed by a world recession that reduced the growth rate of exports and further worsened the non-interest current account, completes the story.

Equation (3) extends (2) to distinguish real from nominal interest rates:

$$(3) \quad K_t = \frac{(1+r_t)(1+gp_t)}{(1+gvk_t)(1+gpx_t)}$$

where  $r$  is the real interest rate  
 $gp$  is the United States inflation rate  
 $gvk$  is the growth rate of the volume of exports  
 $gpx$  is the rate of increase of the dollar price of exports.

Equation (3) focuses on interest rates, inflation and growth. The real interest rate that the developing country borrowers will have to pay depends in part on the real rate of interest in the capital markets of the industrialized world. The real rate of interest in turn is a

function of the fiscal/monetary mix and the level of capacity utilization in the developed economies.

The growth rate of exports from the developing countries will depend on the growth rate of output in the OECD, on the path of the real exchange rate, and on OECD countries' tariffs and other trade barriers impeding exports from the developing countries. Increases in the relative prices of exports of the developing countries, reflected in the ratio  $(1 + g_{px})/(1 + gp)$ , in effect reduce the real interest rate that has to be paid by the developing countries (DCs). Commodity prices are typically highly cyclical, so that the relative price of commodity exports will rise with OECD expansion. Depending on trade elasticities, such changes in the terms of trade will affect debt dynamics in addition through the  $nx$  term. The non-interest current account,  $nx$ , improves with OECD growth and deteriorates with DC growth; it improves as the DCs produce real devaluation, and it improves with the willingness of the OECD to accept imports from the DCs.

Examination of equation (3) thus shows that real devaluation, contractionary domestic policy in the DCs to reduce imports, and a change in the OECD fiscal/monetary mix that reduces the real interest rate, will all unambiguously reduce the debt-export ratio of the DCs. The effects of OECD expansion appear, however, to be ambiguous: OECD growth will increase DC exports, but likely also increase the real interest rate. Which of these effects dominates has to be determined empirically: indeed, it turns out below that this is a key issue in evaluating future debt developments.

We have already noted the importance of distinguishing the real interest rates in the main industrial countries and the real interest rates relevant for debtor countries. The two will differ to the extent that the terms of trade are changing as captured by the term  $(1+g_{px})/(1+gp)$  in (3) above. But there are other important differences, arising first from the spread between list rates (prime, LIBOR) and rates including fees and commissions that are actually paid by borrowers, and second, from the proportion of concessional financing obtained by the DCs. The spread above LIBOR charged the DCs by commercial lenders may be substantial, as high as 2.5 percentage points, and it varies across borrowers.<sup>3/</sup> To the extent that the debt problem is handled by commercial bank lending, this above-LIBOR rate will be the subject of bargaining between lenders and borrowers in trouble.

To summarize our discussion we present an expression for the growth of the debt-export ratio,  $d_t/d_{t-1}$ , in terms of two variables:

$$(4) \quad \text{debt growth} = K_t - \text{Gap}_t$$

The first term summarizes the opposing influences of interest rates and the growth of export revenue in dollars. The second term is the ratio of the resource gap or non-interest current-account surplus to the stock of debt: in the terminology of (2),  $\text{Gap}_t = nx_t/d_{t-1}$ . Neither of these two terms ( $K$  and  $\text{Gap}$ ) is entirely exogenous to the policies of a

debtor country and neither is entirely or even primarily under the control of debtor countries. It is therefore necessary in a historical analysis to disentangle shocks and policy responses in their respective influences on the growth of external debt.

This conceptual framework will now be used to interpret the accumulation of debt in the 1970s, focusing on the relative roles of the world macroeconomic environment and industrial countries' policies.

## II. History

Debt difficulties for isolated countries are common. Debt reschedulings in the postwar period have been frequent (see IMF (1981, 1983b)), but the debt difficulties of the early 1980s are on a different scale. The World Bank (1984, p. xviii), in a survey of debt-relief agreements records 84 separate multilateral reschedulings in the 1975-1983 period: more than three-quarters occurred in the last three years. Of the nearly \$ 90 billion rescheduled in the 1975-1983 period, 85 per cent was in the last three years. The pervasiveness of the debt problem resembles the 1930s when most DCs incurred debt-service difficulties and many defaulted, at least partially, on their external debt. Every country in Latin America, except Argentina, failed to service the debt on the terms contracted. The magnitude of the debt problem, as measured by the debt-export ratio of Latin America, was much the same as today, as table 1 shows. 4/

But even the 1930s were not the first occasion of large-scale debt difficulties, as the following quote from the period suggests:

"The experience of European lending to South America has from the beginning been marked by numerous disasters. Waves of intense optimism, during which almost any properly engraved certificate could be sold at a high price, have alternated with troughs of profound pessimism, in which export of capital stopped completely. Every South American state has been in default at least twice and it still has always, after a greater or lesser delay, been possible for these states to secure funds." (C. Griffin, American Economic Review, March 1935, p. 79.)

Table 1. Debt-export ratio of Latin America  
(Debt as per cent of exports)

1929	1935	1955	1973	1978	1983
149	224	60	176	212	243

Source: United Nations (1964) and IMF (1983).



As a further reflection on the 1930s it is worth remembering that debt-service disruption and actual default occurred in Europe and in Latin America, but not in Asia or Africa.

### 1. Overview and analysis

We start the discussion of debt history in the 1970s by looking at the influence of the external environment. Table 2 and Figures 1 and 2 show details on developments in the world macroeconomy over the period. In table 2 the real price of oil and real commodity prices are measured in terms of the world price level as given by the dollar export prices of industrial countries. Real interest rates are shown for both the United States and for developing countries. By using the dollar price

Table 2. World macroeconomic variables  
(Indices 1980 = 100)

	GDP growth (per cent)	Real oil price	Real commodity price	U.S. prime rate	Real prime rate, U.S. (per cent)	Real prime rate, DCs (per cent)
1970	2.8	17	107	7.9	2.9	10.3
1971	3.6	19	96	5.7	1.5	0.5
1972	5.4	19	100	5.2	-0.5	-27.1
1973	6.0	22	127	8.0	-0.8	-27.4
1974	0.7	62	130	10.8	1.5	12.3
1975	-0.4	60	94	7.9	2.7	2.3
1976	5.0	63	108	6.8	1.0	-8.3
1977	3.9	63	121	6.8	-0.6	3.0
1978	4.0	57	102	9.1	0.4	-7.6
1979	3.2	66	103	12.7	3.5	-2.1
1980	1.3	100	100	15.3	5.6	20.3
1981	1.5	117	87	18.9	12.8	25.5
1982	-0.5	126	81	14.9	11.0	NA
1983	2.3	113	89	10.8	7.0	NA

Source: IMF

- Notes:
1. The first column is the growth rate of industrial countries' GDP.
  2. The real oil price is the price of oil deflated by the export unit value of industrialized countries.
  3. The real commodity price is the index of "all commodities" in IFS (excluding oil) deflated by industrialized countries' export unit value.
  4. The real prime rate, U.S., is the U.S. prime rate minus the rate of change in the U.S. GNP deflator over the subsequent year.
  5. The real prime rate, DCs, is the U.S. prime rate minus the rate of increase of the dollar price of non-oil DC exports over the subsequent year.

of DC exports to deflate the United States prime rate we show how the development of export prices affected the effective cost of borrowing for the DCs. Real commodity prices show substantial variation, from a peak of 130 in 1974 to a low of 81 in 1982; despite dropping in 1983, real oil prices at the end of the period were nearly seven times their 1970 level.

In Figure 1 we show the constituent elements of the real DC prime rate. The early 1970s were a debtor's paradise with large negative real interest rates. But by the late 70s, and especially in the early eighties, the real interest rate was large and positive. The shaded areas identify the periods of positive real interest rates. The measure of real interest rates is certainly very sensitive to the inflation rate used to define it. We use the rate of inflation of DC export prices because dollar export prices reflect the effects of world economic developments on the DCs ability to pay off loans without any change in the volume of exports.

In Figure 2 we show the link between the real price of commodities and industrial production in the major OECD countries. In the early 1970s there was sustained, strong growth and a major boom in commodity prices. In the late 1970s and early 1980s growth of industrial production vanishes and real commodity prices fall to low levels. At the end of the period, commodity prices and industrial production both turn up, but prices are still well below the average levels of the seventies.

Debt statistics: A broad overview of gross external debt developments is given in table 3. The table shows the very large increase in external debt over the 1973-1983 period. It also places that increase in perspective by showing the debt data in constant 1980 dollars. Again we use the industrial countries' export unit value as a measure of the price level in world trade. <sup>5/</sup> While the debt increased in nominal terms by 446 per cent, the increase in real terms was only 165 per cent. This amounted to an average annual growth rate of the real debt of 9.3 per cent; that growth rate, of course, exceeded the average real income growth of these countries and hence external debt increased relative to GDP. Table 3 also shows the debt-GDP ratio, which rose by 67 per cent over the period.

The second point to note in table 3 is the significant differences in the external debt position of different regional groups. Asia shows very small debt-export ratios while the Western Hemisphere leads in size.

A counterfactual exercise: We now place in perspective the relative roles of external factors and domestic policies in the debt build-up. We do this by asking what part of the debt increase would have occurred if the debtor countries, starting from some base year, had in each year pursued policies that ensured a zero non-interest current account. They would accordingly have borrowed only the interest on their existing debt, but no more. Under that assumption would debt-export ratios in the 1970s have increased as sharply as they did?

Figure 1  
INFLATION AND INTEREST RATES

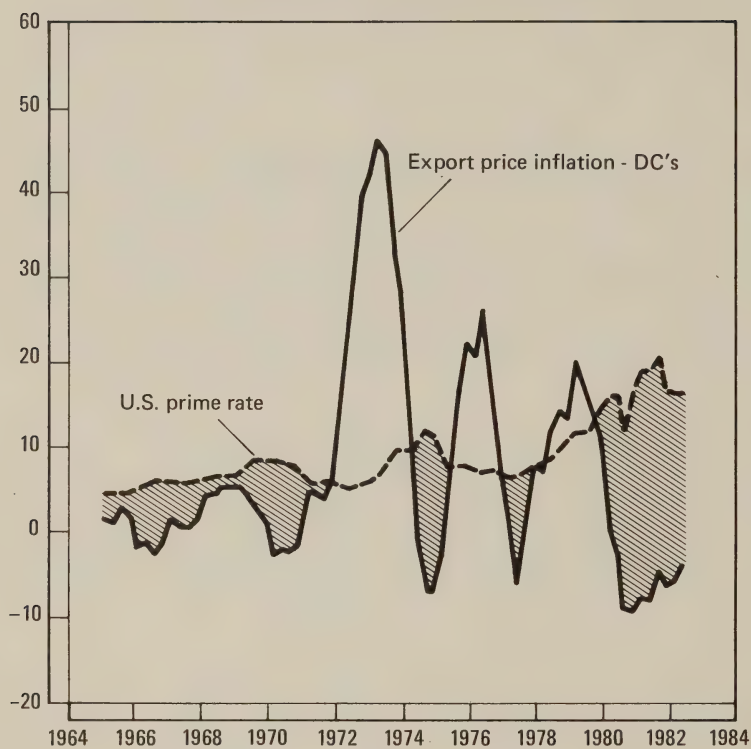


Figure 2  
INDUSTRIAL PRODUCTION AND REAL MATERIAL PRICES

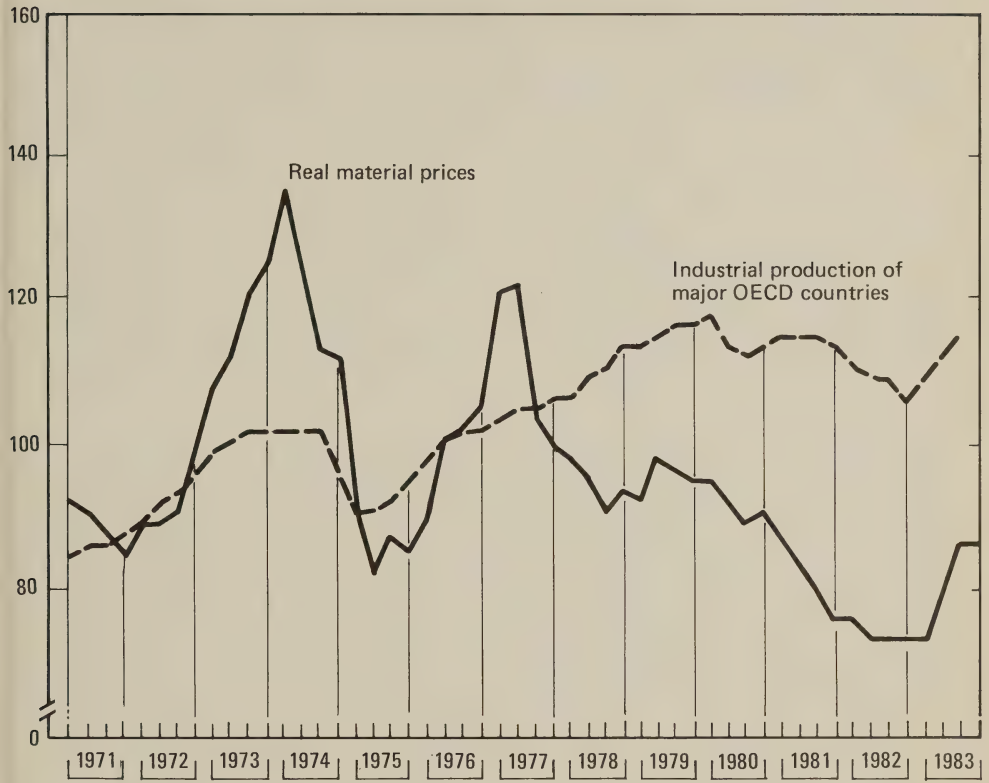




Table 3. Developing countries: external debt outstanding  
(In billions of U.S. dollars)

	1973	1977	1978	1979	1980	1981	1982	1983	1984
Non-oil developing countries	130.1	200.3	334.3	395.3	475.2	559.6	633.3	668.6	710.9
Debt in 1980 dollars <sup>1/</sup>	290.1	413.4	435.3	445.0	475.2	581.7	681.7	744.1	768.5
Long-term and short-term debt by area									
Africa (excluding South Africa)	NA	30.8	36.9	45.3	50.9	55.5	62.5	66.3	70.7
Asia	30.0	68.7	78.7	92.8	114.6	131.2	152.6	165.0	179.3
Europe	14.5	37.6	47.0	55.0	67.2	71.1	72.3	74.8	76.6
Middle East	8.7	21.9	26.7	32.0	36.3	40.6	45.6	50.7	56.2
Western Hemisphere	44.4	109.1	132.4	157.8	192.6	246.0	283.1	294.4	310.5
Ratio of external debt to exports of goods and services (per cent)									
Non-oil developing countries	115.4	126.1	127.7	117.2	111.2	122.5	144.1	149.5	144.7
Africa (excluding South Africa)	NA	135.8	151.1	149.7	143.2	168.6	204.5	223.5	215.8
Asia	92.9	80.7	75.4	68.4	67.5	69.1	79.8	81.4	79.9
Europe	102.4	114.9	123.6	115.8	117.7	110.8	119.4	126.0	121.0
Middle East	145.4	138.9	140.7	134.0	110.7	120.9	136.2	157.2	161.8
Western Hemisphere	176.2	202.9	217.4	198.2	187.0	219.7	274.4	288.5	273.3
Ratio of external debt to GDP (per cent)									
Non-oil developing countries	22.4	23.7	24.1	23.3	23.9	27.1	32.5	36.7	37.5
Africa (excluding South Africa)	NA	35.8	36.6	38.0	35.7	41.5	49.5	59.6	61.8
Asia	19.7	15.7	14.8	14.7	15.9	17.8	20.7	21.4	21.3
Europe	24.5	21.2	23.1	20.9	25.0	28.3	29.2	34.3	37.6
Middle East	36.2	45.0	47.9	56.1	51.7	52.2	52.9	50.6	49.2
Western Hemisphere	23.0	27.9	29.4	27.9	27.3	31.6	42.1	54.8	57.6

Source: IMF (1983, 1984).

<sup>1/</sup> Deflated by index of export unit values for developed countries.

Figure 3 shows the result of the following simple exercise: suppose a hypothetical country at the end of 1969 had a debt-export ratio of 150. Throughout the 1970-1983 period the country is assumed to have a non-interest current account that is balanced, or  $\text{Gap} = 0$  in terms of (4) above. Interest is paid at the actual prime rate. Export earnings in dollars are assumed to grow at the rate at which non-oil developing countries' exports actually grew. The exercise in effect shows what share of the current debt is due to (non-interest) current account deficits over the 1970-1983 period.

Figure 3 shows that starting from an initial level of 150 per cent in 1969 the debt-export ratio in 1969 would have ended by 1983 at a level of 79 per cent. The most striking features of Figure 3 are: the extraordinarily rapid reduction of the hypothetical debt-export ratio from 1969 to 1974 as the real rate of interest is negative and exports grow fast; and the rapid increase in the hypothetical debt-export ratio from 1980 to 1983 under the influence of large positive real rates and weak export performance.

Figure 3 tells us, as a first approximation, that external circumstances -- interest rates and export growth -- cannot by themselves account for the severe increase in debt problems over the 1970-1983 period. Over the 1973-1983 period the debt-export ratio would have remained unchanged if the non-interest current account had been balanced. Instead it increased by 64 per cent. Non-interest current account imbalances are clearly an essential part of the debt problem. These non-interest current account imbalances in turn are linked to short-run and long-term macroeconomic developments: investment trends, budget deficits, private sector saving, disequilibrium exchange rates, and to the manner in which some of these domestic variables responded to external shocks.

Figure 4 focuses further on the influence of the external environment in terms of interest rates and growth of dollar export earnings. The Figure shows the ratio  $K_t$  of equation (4) for the period 1950-1983 using the United States prime interest rate and the actual growth of non-oil DCs exports. The interesting point to note is the relation between Figures 3 and 4. The peaks and troughs in the debt-export ratio of Figure 3 are related to successive realizations of  $K$  above or below unity. Thus the runs of 1971-1983 and 1975-1980 lead to a cumulative decline in indebtedness. On the other side a sequence of high values of  $K$  in 1980-1983 leads to a build-up of indebtedness.

A further point to note about Figure 4 is the much larger volatility in the 1970-1983 period than in the period from the end of the Korean War (1954) to 1970. Table 4 shows data for different subperiods that bring out this fact.

Table 4 shows important differences in the subperiods. The most recent period features more adverse conditions for debtors since the average value of  $K$  significantly exceeds unity. A country that had

Figure 3  
HYPOTHETICAL PATH OF THE DEBT-EXPORT RATIO

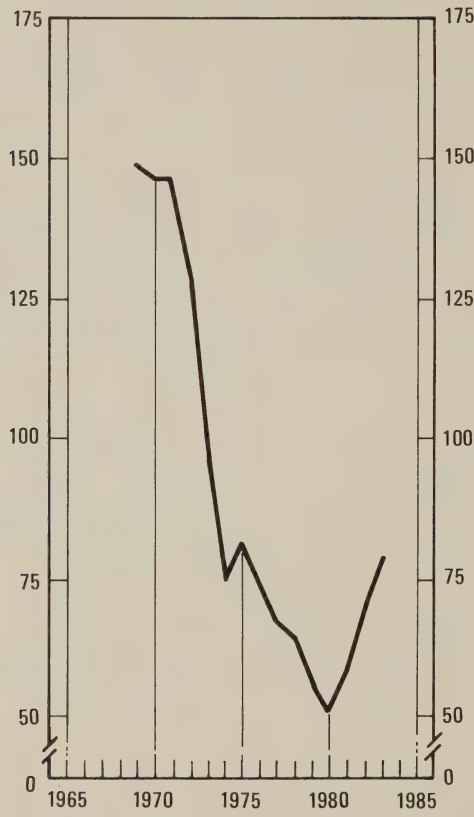


Figure 4  
THE COEFFICIENT K

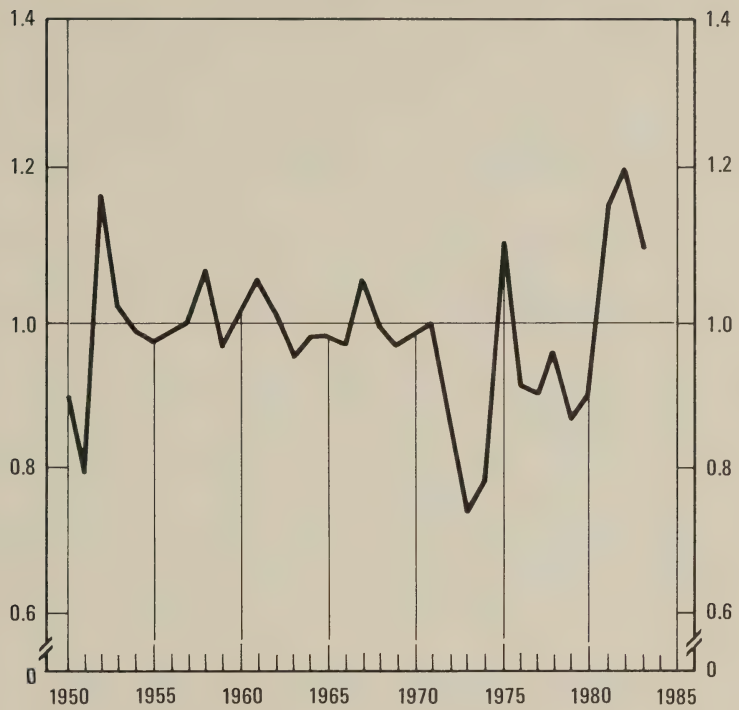




Table 4. The debt growth coefficient K

	1950-1970	1954-1970	1970-1983	1978-1983
Average	0.99	1.00	0.96	1.03
Standard Deviation	0.07	0.03	0.13	0.13

followed in this recent period a policy of rolling over a given initial debt, borrowing the capital to finance interest charges, would have experienced debt growth, relative to exports, at an average rate of nearly 3 per cent per year.

The relative role of the world environment and domestic policies is brought out by considering the period dominated by unfavourable external shocks, 1980-1983. Table 5 shows for different groups of non-oil DCs the actual percentage increase in the debt-export ratio and the percentage increase associated with a balanced non-interest current account, debt service at prime rate, and the actual export growth of the region. Except for Latin America, the actual percentage increase in the debt-export ratio matched or fell short of what would be implied by the hypothetical path. In these cases, countries were reducing their debt relative to exports by running current-account surpluses.

Table 5. The external shock of 1980-1983

	Actual % Rise	Hypothetical % Rise
Non-oil DCs	23.0	25.5
Africa	36.6	65.4
Asia	16.7	16.5
Middle East	1.6	18.2
Latin America	38.4	24.4

The evidence in table 5 points to the common external shock as one force that greatly increased external indebtedness. But the differences between regions are significant. The large increase in Latin American debt-income ratios represents both non-interest current account deficits and differences in effective interest rates that are not captured in our hypothetical scenario.

Up to this point we have used the United States prime rate to represent the average DC borrowing rate. But, as table 6 shows, effective interest costs vary substantially. The effective interest

rate (total interest as a fraction of total debt) depends on the terms at which external debt was acquired: at concessional or market rates, at fixed or floating rates, whether public or private, whether short- or long-term. Given the recent history of rising interest rates, the effective interest rate will be higher the larger the share of private, floating-rate debt. This effect is further reinforced by the fees and commissions associated with rescheduling of private debts and, of course, with the spread over LIBOR on private debt. Table 6 shows that part of the differences in table 5 between Latin America and the other groups reflects these differences in effective interest rates.

Table 6. Effective interest cost  
(per cent)

	1979	1980	1981	1982	1983
U.S. prime rate	12.7	15.3	18.9	14.9	10.8
LIBOR	12.1	14.2	16.8	13.2	9.6
Total DC debt*	7.7	9.0	9.7	10.0	8.7
Fixed interest	5.8	6.0	6.0	6.3	6.7
Floating rate	12.3	15.5	17.4	17.1	12.7
Lower income countries*	3.8	3.8	3.8	4.0	3.7
Lower-middle income countries*	7.3	8.7	9.0	9.8	8.3
Upper-middle income countries	9.3	11.0	12.1	12.2	10.6
Major developing borrowers**	7.6	9.2	11.1	11.5	9.4
Major Latin borrowers**	8.4	10.1	12.4	13.4	10.8
Major Asian borrowers**	6.8	8.7	10.1	9.8	8.0
Major Middle-East and African borrowers**	6.5	7.7	8.7	8.3	7.3

Sources: OECD (1984), Morgan Guaranty, DRI and IMF.

\* OECD, \*\* Morgan Guaranty.

Table 6 shows that effective interest costs are below LIBOR or the prime rate, though by 1983 they are equal to LIBOR in the case of Latin America. <sup>6/</sup> This is the case even though front-end fees, commitment fees and spreads significantly increase the cost of debt obtained from banks. The World Bank (1984) reports that average spreads on new credits to oil-importing countries were 1.86 percentage points, up from 1.11 percentage points in 1982. Brau et al. (1983) report details on fees in recent reschedulings and show that they fall in the range of 2 to 3 percentage points. These facts along with the level of LIBOR and the United States prime rate must be borne in mind in interpreting the effective interest cost in table 6. The inference is that poor countries have borrowed predominantly at fixed and concessional rates. By contrast, major Latin borrowers have so significant a component of

bank debt that spreads and fees nearly offset the low-interest part of their debt.

We return to the interest rate issue later in the paper where we discuss the impact of current interest rate developments on the sustainability of the "muddling-through" approach to the debt problem. The difference between borrowers already noted here becomes important at that point.

## 2. Some econometric evidence

The behaviour of interest rates and of aggregate DC dollar export growth is of course governed predominantly by the macroeconomic conditions of industrial countries. Policies in DCs do affect individual country experiences, but for the present we assume that there is sufficient independence of their policies so that aggregate non-oil DC export performance is largely determined by the macroeconomics of the industrial countries.

Consider now the determinants of the growth in export volume of non-oil DCs. Considering the period 1954-1982, using annual data, we explain export volume growth in an OLS regression on the current growth rate of industrial countries' real GDP. The constant term is allowed to differ in the 1971-1982 period from the earlier period by using a dummy that assumes a value of unity in these years and zero elsewhere.

$$\text{Export Volume Growth} = -.19 + 4.49\text{DUM} + 1.15\text{INDGrowth} \quad \bar{R}^2 = .41 \quad \text{DW} = 2.0 \\ (-.13) \quad (3.73) \quad (3.85)$$

In the 1970s export volume grew at an annual rate of 4.5 per cent higher than in other years, given the growth rate of the developed countries. In addition, every extra point of OECD growth raises export volume growth by 1.15 percentage points. There is thus a significant effect of growth in industrial countries on the export performance of non-oil DCs. Note that although the equation explains only 40 per cent of the variation in export growth the impact of industrial countries' growth is highly significant, as suggested by the high t-ratio, and there is no indication of serial correlation pointing to systematic omitted variables.

We also examined the determinants of the real price of commodities. We measured the real price by deflating the IMF dollar price index of all commodities (excluding oil) by the dollar index of industrial countries' export prices. The growth in the real commodity price in the period 1958-1983 is explained by industrial countries' growth:

$$\text{Real commodity Price growth} = -10.5 + 2.67 \text{INDGrowth} \quad \bar{R}^2 = 0.24 \quad \text{DW} = 2.02 \\ (-2.7) \quad (3.0)$$

Once again the equation explains only a small part of the variation in the dependent variable. But industrial countries' growth appears as a significant determinant. An extra percentage point of growth raises the real commodity price by nearly three percentage points. But in the absence of growth there is a steep downward trend at a rate of 10.5 per cent per year. This trend effect is largely offset during the sample period, by an average growth of developed countries at a rate of 3.7 per cent. In combination with the elasticity of about 2.7 this is sufficient to keep the real price of commodities approximately constant.

We have not had much success in pinning down the determinants of the real price of non-oil developing countries' exports. The variable we tried to explain is the non-oil DCs export unit value deflated by industrial countries unit value of exports. Current growth in industrial countries, or changes in growth do not appear significant. Lagged growth changes, however, are significant and remain so in different subperiods. We must add though that there is no theoretical basis for the claimed relationship between growth in real export price and the change in lagged growth rates. 7/

The results we have obtained show that a one-percentage-point increase in industrial countries' growth raises the real commodity prices by 1.3 percentage points. This is a one-time only increase associated with a change to a higher growth rate. Thus the effect is quantitatively small and, as already noted, theoretically hard to defend. We give it attention because in some debt scenarios, specifically Cline's (1984), the cyclical recovery of real commodity prices plays a quantitatively large role.

Figure 5, which shows the real commodity price series, also suggests why it is difficult to explain. The series is dominated by two periods of extreme change, 1970-1975 and 1977-1978. Any attempt at sorting out the role of oil, industrial countries' growth, and the dollar in these price movements fail because there are simply not enough episodes to do so in a robust way. This point is reinforced by differences between country groups and by supply-side factors that are neglected in equations that focus uniquely on cyclical effects.

The empirical evidence on the growth in export earnings and its relation to OECD growth is broadly summarized by equation (4). Here we look at growth in export earnings of non-oil DCs. They are explained by inflation in world trade as measured by the growth rate of the unit export values of industrial countries, INF, and by real growth, INDGrowth, already discussed above and a 1970s dummy, DUM. The last term INF3 is introduced to capture an apparent non-linearity in the response to inflation and is the cube of INF.

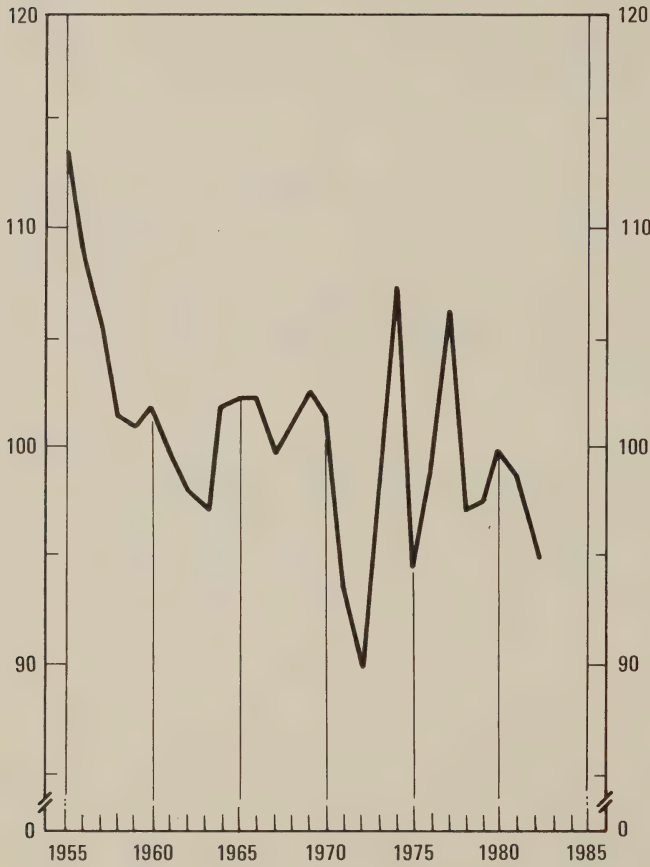
$$(4) \text{ Export revenue} = -6.7 + .76\text{INF} + 2.4\text{INDGrowth} + .0015\text{INF}^3 + 5.8\text{DUM}$$

$$\text{Growth} \quad \quad (-2.1) \quad (2.7) \quad (3.9) \quad \quad (2.6) \quad (2.1)$$

$$\bar{R}^2 = .83 \quad \text{DW} = 1.92$$



Figure 5  
THE REAL PRICE OF NON-OIL DEVELOPING COUNTRIES EXPORTS  
(index 1980 = 100)



The equation shows that export earnings grow approximately one-for-one with world inflation. Industrial country growth translates with a coefficient of 2.5 into earnings growth. Finally, for the post-1970 period there is roughly no trend growth. Taking into account evidence from further work not reported here, we conclude that the link between export revenue growth and industrial countries' growth is about 2:1. To give a range one might say that a one-percentage-point-increase in industrial countries' growth raises export revenue growth by 1.5 to 2.5 percentage points. But as a working number 2:1 best summarizes all the available evidence. <sup>8/</sup> We return to this relationship in examining alternative debt scenarios.

### 3. Special cases

Following the global overview we now examine data for specific countries, to emphasize the large differences among countries and to discuss, briefly, the variety of reasons for debt difficulties. Table 7 shows the behaviour of total debt and the debt-to-export ratio for several countries. They are mainly the big Latin American debtor countries, but also an oil-producing country and examples from Asia and Africa.

Table 7. External debt and debt-export ratios

	1975		1983	
	Debt (\$US)	Debt/Exports (per cent)	Debt (\$US)	Debt/Exports (per cent)
Non-oil DCs	116.0	92.7	710.0	144.7
Argentina	7.9	171.3	45.3	452.0
Brazil	26.0	236.6	93.1	364.9
Chile	5.4	282.3	18.6	374.9
Mexico	22.5	263.8	89.8	315.3
Venezuela	5.5	44.1	44.9	200.5
Nigeria	1.3	14.3	17.0	126.0
Indonesia	9.7	131.4	29.5	136.1
Republic of Korea	11.6	171.9	40.1	125.0

Source: Morgan Guaranty.

Note: The debt/export ratio is calculated by averaging current and past year-end debt and dividing by current year exports of goods and services.

The comparison is made between 1975 and 1983 because there are no very reliable debt data for the earlier part of the 1970s. But it is worth commenting briefly on the earlier debt positions. The 1970 data,

imperfect as they may be, show that Mexico and the Republic of Korea had debt-export ratios of 347.0 and 331.2 respectively. This is of interest because the ratios were as high then, if the numbers can be trusted, as are the ratios of crisis countries today. Of course, as Figure 1 suggests, the high debt-export ratios of 1970 were sharply reduced by the negative real interest rates up to 1973; no such relief is in sight currently.

Table 7 makes it clear that the Latin American debt situation is quite different from that of other large borrowers, in particular the Republic of Korea. The debt-export ratios are much higher and, indeed, started off higher in 1975 than they are today for the other countries shown. Both the absolute size of the debts and the magnitude of the debts relative to exports stand out.

The second point to note in table 7 is that the debt-export ratios did not uniformly increase. On the contrary, the Republic of Korea is an interesting example because here a significant increase in external debt was matched by even larger export growth. This difference, as we will note below, reflects in part a different pattern of adjustment to external shocks between the Republic of Korea and Latin American countries, and in part it reflects a different economic structure. Specifically, the Republic of Korea is a material importer and as such benefits from a collapse of commodity prices whereas other DCs are net exporters of commodities and therefore are hurt.

The reasons for debt accumulation vary across countries. In some cases they include, perhaps even predominantly, investment booms. In other cases they represent lack of adjustment to external interest rate or terms of trade shocks, the financing of capital flight, or the flight into importables under the incentive of currency overvaluation. The experience of several Latin American countries points to the interaction of domestic policy mistakes and world macroeconomic developments. Domestic expansionary policies financed by external debt accumulation were pursued on a very large scale. A course that could have been corrected with reasonable difficulty then became extraordinarily difficult and costly to correct once world interest rates escalated in world markets and commodity prices plummeted. The interaction lies in the fact that the domestic policies led to an overexposure in terms of external debt which then was vastly magnified by the world macroeconomic shocks. 9/

We also examine in more detail the cases of Mexico and the Republic of Korea, to examine both domestic DC causes of the debt problem and alternative strategies for dealing with it. Mexico's debt problem arose from three domestic causes, as well as the external developments studied earlier. The three domestic causes were capital flight, flight into importables, and extremely large public sector investment, deficits and imports. While the oil discoveries helped reduce the large external indebtedness (relative to exports) of the early 1970s, poor policies in 1980-1982 together with a softening of oil prices more than compensated and ultimately led to the 1982 suspension of debt service. 10/

Table 8 shows the key Mexican indicators in the period 1978 to 1982. The table shows the sharply rising budget deficit and a matching external debt increase. The large public sector deficit spilled directly over into imports and a trade deficit. But it also gave rise to inflation and overvaluation and therefore to capital flight in anticipation of depreciation. The real exchange rate, measured by Mexican relative to United States consumer prices, appreciated by more than thirty per cent in the 1978-1981 period thus creating the firm expectation of depreciation. Maintenance of fixed rates and an open capital account meant that there was no means to stop the capital outflow. The corrective devaluation, however, occurred only in late 1982 once the large external debt had already been incurred.

It is important to distinguish gross from net external debt in the Mexican case. 11/ Significant private capital outflows meant that the government was in effect borrowing abroad using the proceeds to finance private acquisition of foreign assets. This acquisition of private assets abroad is to a limited extent reflected in the non-bank Mexican claims on the banking system of the major industrial countries. Data reported by the Federal Reserve show an increase of deposits with United States banks by residents of Mexico between 1980 and 1982 of 4 billion.12/ This does not take into account deposits in other countries or purchases of dollar currency, securities and real estate.

Table 8. Mexican macroeconomic indicators

	1978	1979	1980	1981	1982
Budget deficit (per cent of GDP)	5.5	6.0	6.9	13.6	16.3
Inflation (Dec. to Dec.)	17.5	18.2	26.4	27.9	58.9
Real exchange rate (index 1980=100)	117.0	113.5	100.0	90.6	137.9
External debt (U.S. billions)	34.0	40.4	52.5	78.9	84.6

Source: Informa Hacendario Mensual, November 1983, IFS and Morgan Guaranty.

There is an interesting difference between the Latin American debtors and the Republic of Korea. The Republic of Korea is a major oil importer, and is also a major debtor. It is therefore subject to the same shocks as many other DCs. But the response and the outcome in terms of external debt has been very different from the average as table 9 shows.



Perhaps the most interesting aspect of the Republic of Korea's experience is that there is no simple story. The budget was in increasing deficit over the period, and the debt did increase rapidly. The major difference is in the behaviour of the real exchange rate. In the case of the Republic of Korea unit labour costs in dollars have declined, securing a strong gain in external competitiveness and therefore a reduction in the non-interest current account deficit. This happened despite continued high growth, after 1980, and despite the oil price increase. The strategy of using the real exchange rate as a means of sustaining growth, particularly in the case of adverse shocks is apparent from the rise in the ratio of exports to GDP. In 1978 that ratio was 33.4 per cent. By 1982, the export share had increased to 38.9 per cent. We shall return to this point in the context of adjustment programmes.

Table 9. Republic of Korea macroeconomic indicators

	1978	1979	1980	1981	1982
Growth	11.6	6.4	-6.2	6.4	5.4
Budget deficit (per cent of GDP)	2.7	1.6	3.6	4.3	4.5
Unit labour cost (In \$US, 1978=100)	100	111	98	90.8	92.6
External debt (\$US billions)	17.8	21.5	26.7	32.3	37.2

Source: Morgan Guaranty, Republic of Korea Economic Indicators, Park (1984).

The Republic of Korea and Latin American borrowers also differ in respect to the economic structure. The former imports materials and exports manufactures. Brazil, Chile or Argentina, by contrast, are substantially commodity exporters even though manufacturing has become important. This explains the very different behaviour of the terms of trade for these countries. For Brazil, the terms of trade deteriorated by nearly 50 per cent in the 1978-1982 period, but for the Republic of Korea they deteriorated by only 16 per cent. The smaller terms-of-trade deterioration of course eases the adjustment process and, indeed, dispenses with the need for severe adjustment, at least until the terms of trade move adversely during the cyclical recovery.

### III. Scenarios

#### 1. The spectrum of views

"There is not much doubt that the debt-export ratio will decline." 13/

"The central conclusion of this study is that with reasonable recovery in the global economy, the problem of international debt should prove manageable and the degree of its current risk to the international system should decline." 14/

"Yet the view from Latin America is less sanguine. Governments there see the crisis as a growth crisis." 15/

Debt scenarios abound, ranging from rosy to gloomy. The key assumptions in constructing a scenario are highlighted in equations (2) and (3): the behaviour of the real interest rate, the growth rate of developing country exports, and the ratio of the non-interest current account to exports are the ingredients needed to forecast the evolution of debt-export ratios. In this section we describe and evaluate the typical 1983 models and assumptions, arguing that they are excessively optimistic.

The most optimistic view is taken by the United States Council of Economic Advisers. Its forecast is based on a variant of equation (2) that requires no explicit interest rate assumption. The CEA focuses on the ratio of the current account deficit (as opposed to the non-interest current account) to the external debt,  $cd$ . Using the approach of equation (2), the evolution of the debt-export ratio is: 16/

$$(5) \quad d_t = d_{t-1} / (1 + g x_t) (1 - cd_t)$$

Equation (5) shows that the debt will decline relative to exports provided the current account deficit as a fraction of debt is sufficiently less than the growth of export earnings. For example with a growth rate of export earnings of 10 per cent the current account deficit must be less than 9.1 per cent to ensure a declining debt-export ratio.

The CEA's forecast is based on the observation that the current account deficit ratio for the ABM countries (Argentina, Brazil and Mexico) in 1983 was only 2.8 per cent, which is certainly well below the likely growth rate of exports. However, the 2.8 per cent current account deficit of 1983, reflecting a trade surplus of \$ 20 billion, about 4 per cent of GNP, may not be sustainable if satisfactory growth in the ABM countries is to resume. It is therefore necessary to look at more detailed projections.

Table 10 summarizes base-case assumptions made in several well-known studies. (The behaviour of the non-interest current account

is not assumed directly, but rather follows from assumptions about OECD growth and developing country exchange rates and growth.) The most striking uniformity is in the assumed OECD growth rate of around 3 per cent. This is well above the 2.5 per cent growth rate for 1973-1980, but below the 3.5 per cent average for the 1976-1980 recovery period.

Table 10. Base case assumptions for debt projections

Study	Countries	Horizon	OECD growth (% p.a.)	Real interest rate	DC export growth (real, %)
Cline <sup>1</sup>	18 largest debtors <sup>2</sup>	1983-86	2.6	3.8	8.76
Dooley et al. <sup>5</sup>	8 large debtors <sup>4</sup>	1983-90	2.9	6.0	8.6
Enders & Mattione <sup>5</sup>	7 Latin Am. countries <sup>6</sup>	1983-87	3.0 <sup>7</sup>	4.2	1.6 <sup>8</sup>
Morgan Guaranty <sup>9</sup>	21 large borrowers <sup>10</sup>	1983-90	3.0	2.7 <sup>11</sup>	5.0

- Notes: 1. William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, Washington, D.C., 1983.
2. Algeria, Argentina, Brazil, Chile, Ecuador, Egypt, Hungary, Indonesia, Israel, Mexico, Peru, Philippines, Portugal, Republic of Korea, Romania, Turkey, Venezuela, Yugoslavia.
3. Michael Dooley, William Helkie, Ralph Tryon and John Underwood, "An Analysis of External Debt Positions of Eight Developing Countries through 1990", Federal Reserve Board, International Finance Discussion Paper No. 227, August 1983.
4. Argentina, Brazil, Chile, Mexico, Peru, Philippines, Republic of Korea, Venezuela.
5. Thomas O. Enders and Richard P. Mattione, "Latin America: The Crisis of Debt and Growth", Brookings Discussion Papers in International Economics, No.9, December 1983.
6. Latin American countries in note 4 above, plus Colombia.
7. Paper presents only growth rates for the United States and four European countries.
8. Calculated for 1982-1987. Exports in 1983 were below the 1982 level.
9. Morgan Guaranty Trust, World Financial Markets, June 1983.
10. Same countries as in note 2 above, minus Hungary, Portugal, Romania and Yugoslavia, and plus Colombia, Taiwan Province of China, Thailand, Ivory Coast, Morocco and Nigeria.
11. All rates are averages over indicated periods.

The real interest rates shown vary substantially. The interest rates in the table are averages over the relevant period; within that period each forecast has the real rate falling steadily. The real rate relevant to the developing countries' debt problem is currently about 6 per cent real, and - as we discuss below - is unlikely to fall substantially by 1986. Despite the large uncertainties about future real rate behaviour, the assumed 6 per cent real rate in Dooley *et al* is a more likely outcome than the other interest rate assumptions listed in table 10. We return to this point below.

The growth rate of developing country exports is, in all but one of the cases, well above the growth rate of OECD output. These high growth projections reflect both assumed income elasticities of demand by the OECD countries in the range of 2 and higher, and real devaluations in the developing countries. Real non-oil developing country exports grew at more than 11 per cent over the period 1973-1979, so that the assumed growth rates of exports -- like the assumed real interest rates -- are well within the bounds of recent experience. Part of that experience, the growth of intra-DC trade, has fallen victim to the debt crisis. None the less, given good behaviour by governments in both importing and exporting countries, the median trade assumption of about 5 per cent growth per year in table 10 is probably within reach.

Table 11 shows where these basic assumptions together with specific models and other needed assumptions lead. <sup>17/</sup> Every scenario shows a reduction in the debt-export ratio, with the 1986 ratio being in all cases only about 87 per cent of the ratio in the benchmark year 1983. Every scenario shows the nominal debt of the relevant group of countries rising over the period, and generally rising in real terms. Every scenario shows the current account deficit (that is, including interest

Table 11. Base case debt projections

Study	Debt				Debt/Exports		Curr. Acc. Def/Exports	
	1982 (\$ billions)	1986 (\$ billions)	Ratio 1986/1982	Ratio real debt	1982	1986	1982	1986
Cline	484	676	1.40	1.15	1.87	1.62	.22	.13
Dooley	298	363	1.22	1.05	2.29	1.87	.27	.17
Enders	283	331*	1.17	0.98	2.91	2.52	.15	.07
Morgan	514	660*	1.28	1.00	1.78	1.57*	.22	.07*

Notes: Sources are specified in table 10.

\* indicates number is obtained by interpolation.



payments) falling relative to exports over the period. Because none of the groups overlap exactly, it is not possible at the aggregate level to compare the projections of different authors. We will make such a comparison in the case of Brazil below.

At the aggregate level of table 11, all seems well, even in the case of the most pessimistic of the authors, Enders and Mattione, who show falling debt in real terms and very small current account deficits by 1986. Their pessimism is based in part on the high debt-export ratio of the group they analyze. Debt reschedulings, and implied IMF-monitored restrictive domestic policy, are more likely with high debt-export ratios. 18/

More importantly, the low DC growth rates that accompany the Enders-Mattione scenario justify their pessimism. Growth for their group averages a little above 1 per cent for 1983-1987, which implies falling per capita output; growth is minus 1 per cent for Brazil over that period. Cline shows growth rates averaging a little below 4 per cent for 1983-1986. The other projections do not show explicit DC growth paths. In the case of Dooley et al, details of DC growth were not needed since to close the model it was assumed that IMF current account targets would be met.

The aggregate projections conceal much of the important information about the debt problem. Indeed, it is quite fundamental that the international debt problem is centred on a few countries. Brazil may be highest on the list. Examination of the projections for Brazil will not only show the dimensions of that country's problem, but also enable us to compare the projections of different authors.

Table 12. Debt and export projections, Brazil, 1986

Study	Current a/c, (\$ billions)	Debt (\$ billions)	Debt/Exports		Average Growth 1983-1986
			1983	1986	
Cline	-0.6	92.3	3.46	1.97	4.0%
Dooley	-15.4	121.5	3.91	3.54	N/A
Enders	N/A	103.7*	3.97	3.12*	-1.2
Morgan	-5.5	108.1	3.67	3.10	N/A

Notes: Reference in table 10.

\* indicates interpolated.

Table 12 shows extraordinary variation in the evaluation of Brazil's economy over the 1983-1986 period. At one extreme is the Cline scenario with strong growth -- 6 per cent per year in 1984-1986 after a 1983 decline. Because, as we will discuss below, the external environment is favourable in this scenario and Brazilian export revenues are assumed highly responsive to foreign growth, the debt-export ratio falls by 1986 to almost half its 1983 level. The next section investigates this set-up in more detail to point out that there is no reason to place much confidence in this scenario. By contrast, the Enders-Mattione scenario is definitely not optimistic. Even with a dismal growth performance -- per capita output falls by 3.5 per cent per year -- the debt-export ratio is reduced only by 25 per cent. Similarly Dooley *et al* and Morgan Guaranty do not support the optimism that the Cline scenario would inspire.

## 2. An evaluation of the Cline approach

The work by Cline (1983a, 1983b, 1984) is certainly the most widely quoted of the various scenarios. The influence derives in part from the fact that the analysis sets out a well-developed, disaggregated framework and uses econometric estimates of the parameters as key inputs for various scenarios. The careful documentation and the explicit spelling-out of the model and the assumptions about key variables makes it possible to take issue with the formulation and to question the optimism.

Our disagreement comes from two points. The first is that the base-case assumptions about the external environment are becoming increasingly implausible. The second is to question various key building blocks of the econometric model. We argue that OECD growth is less and interest rates are more important than the Cline analysis makes them out to be. Specifically, we disagree with the central finding of Cline (1983a, p.65; footnote in original).

"Thus on average [a] one percentage point change in OECD growth is seven times as powerful as each percentage point change in the interest rate in remedying the debt problem. 63

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63 Based on the model's equations, 1 per cent OECD growth raises exports of goods and services by 3 per cent in volume, and by an average of approximately 3 per cent in price, for a total of 6 per cent export increase. Considering that net debt is 1.87 times exports of goods and services, and that two-thirds of the debt is indexed to LIBOR, a 1 per cent reduction in the interest rate cuts interest payments by 1.2 per cent of exports of goods and services. On the basis of these parameters, without adjustment for differing weights of countries, a 1 per cent rise in OECD growth would have an impact equivalent to a 5 percentage point reduction in LIBOR."

Cline's claim poses an important issue. For the present at least, industrial countries' recovery is underway and is particularly strong in the United States. Hence, on the Cline predictions, the debt problem is

well on the way to a solution. But the recent sharp increase in prime rate suggests that this may not in fact be the case. The increases in interest rates may precipitate an unexpected liquidity problem that we spell out below. First, we look at model issues.

Model issues: A central part of Cline's model is the equation describing non-oil developing countries' exports. The growth rate of the dollar value of exports is given by the following expression:

$$(6) \text{ Export revenue growth} = [1+ay_t][1+b\Delta y_t][1+c\Delta y_{t-1}][1+e][1+p] - 1$$

(per cent per year)

where

y industrial countries' output growth  
 y change in industrial countries' output growth  
 e percentage dollar depreciation (effective rate)  
 p world inflation

and the terms a, b and c are elasticities. 19/

Equation (6) identifies five different effects that determine the growth of dollar export revenue. The most obvious is growth in revenue due to world inflation which is captured by the term  $1+p$ . The second item is growth in export volume due to OECD growth captured in the term  $(1+ay_t)$ . Dollar depreciation is assumed to be one-for-one reflected in higher prices as shown by the term  $(1+e)$ . In other words, a 10 per cent depreciation of the effective dollar exchange rate would lead to a 10 per cent increase of dollar prices in world trade. Finally changes in growth of industrial countries exert a once-and-for-all effect on earnings growth over a two-year period as captured by the terms  $(1+b\Delta y_t)(1+c\Delta y_{t-1})$ .

Cline (1983) assumes that an extra percentage point of growth in the OECD area raises DC export volume growth by three percentage points. We showed evidence above that the relationship is more nearly 1:1 or 2:1 or, in terms of (6) above,  $a=2$  at most. We have been able to establish no evidence of an elasticity significantly larger than two for non-oil DCs as a group. In comparison with Cline we find a positive intercept (4.3 for the 1970s as opposed to Cline's -3.0) and there is a corresponding reduction in the elasticity with respect to OECD growth. The difference in specification reflects the fact that non-oil DCs in the 1970s diversified their exports to oil-producing countries. We capture this diversification in the higher time trend. 20/

The second point of difference concerns the impact of changes in OECD growth on the real export price of DCs. Cline (1984, table B1) reports estimates of these effects which, in the case of Brazil for example, are  $b=1.9$  and  $c=2.4$  or a sum of 4.3. A cyclical recovery of growth therefore has a very potent once-and-for-all impact on export revenue. OECD growth moving from 0 to 3 per cent over the 1982-1984 period would add a once-and-for-all bonus of 13 per cent to export

revenue. Our estimate of this effect reported above finds a significant lagged growth rate change with a coefficient of merely 1.6. For the case of Brazil, the estimated effect is only 2, not 4.4. The cyclical revenue recovery, on our estimate, therefore is significantly smaller.

A third point of difference concerns the impact of dollar devaluation. In Cline's formulation a dollar depreciation raises the export prices of non-oil DCs in the same proportion. No evidence whatsoever is offered for this assumption, which differs from the rule of thumb that dollar prices in world trade rise by about half the change in the effective dollar exchange depreciation. The difference is significant because Cline's base scenario assumes a large dollar depreciation. He therefore probably overestimates the export revenue gains that should be attributed to dollar depreciation.

While we differ with Cline's analysis on these specific points, there can be no disagreement with the fact that DC exports do have a strong cyclical component. Although the data do not allow us to find out very precisely what this cyclical effect is, our own work leads us to believe that Cline's 6:1 assumptions for the total impact of OECD growth on export earnings' growth is a large overestimate. This is all the more so because part of the Cline effects are, in his own specification, transitory and would disappear after the two-year adjustment to a sustained growth increase. A 2:1 relation represents a more plausible estimate.

A fourth and important disagreement with Cline centres on the role of interest rates. Cline recognizes that the impact of interest-rate increases differs among countries depending on their debt-export ratio and on the part of debt that is indexed to LIBOR. For the base-line case he assumes a debt-export ratio of 1.87 and a fraction of debt that is indexed to LIBOR of two-thirds. With these assumptions a one percentage point rise in LIBOR raises interest charges by 1.2 ( $=1.87 \times .66$ ) per cent of exports of goods and services whereas an extra percentage point of OECD growth raises export earnings by 6 per cent with the 6:1 rule.

But these numbers are not realistic for the large debtor countries, specifically Brazil or Argentina. In Brazil, bank debt alone, not counting debt to official creditors, stands in a ratio to exports of goods and services of 3.0. 21/ Assuming that all bank debt, unlike official debt, is indexed fully to LIBOR a sustained one percentage point increase in interest rate raises debt-service charges by 3.0 per cent of exports. In this case an extra point of OECD growth is less powerful (or even much less), not five to seven times more powerful, than a one percentage point reduction in interest rates. Much the same numbers apply to Argentina and also to Mexico. For the large debtors, then, interest rates and OECD growth rates have quite similar effects.

The macroeconomic outlook: Aside from model specification issues we differ from Cline, with the benefit of 1984 information, in respect to



the macroeconomic outlook. Cline's study offers different scenarios but in his main analysis, and certainly in the way the study has been received, the definitive optimism of the baseline case stands out. Table 13 shows Cline's base-case assumptions.

Table 13. The case assumptions of the Cline study and actual data  
(Annual average percentage rate)

	OECD Growth	LIBOR	Inflation	Effective dollar depreciation
1983	1.5 (2.4)*	10 (9:6)	5 (5.5)	5 (-3.6)
1984	3	9	5	9.5
1985-86	3	8	5	0

Source: Cline (1983) and OECD (1984).

\*Numbers in brackets represent actual data.

We showed above that two factors work in a particularly strong fashion in Cline's analysis to solve debt problems: OECD growth and dollar depreciation. Cline's growth forecasts are certainly on track; indeed they may even be low. However, his forecasts for interest rates and dollar depreciation by mid-1984 are highly optimistic for the DCs. We argue below that there is a good chance that interest rates will keep rising, perhaps only 150 basis points but quite possibly as much as 300 points, the increase bringing with it a strong reduction in growth and the possibility of further dollar appreciation. How would such a scenario change the Cline conclusions within his own model? Higher interest rates have very little effect. Cline (1983, p.64) shows that if LIBOR averaged 13.5 per cent instead of 8.75 per cent the debt-export ratio would still decline. But the decline would only be from 1.87 to 1.81 instead of 1.67. In the same way, less dollar depreciation -- 5 instead of 15 per cent -- still brings down the debt-income ratio to 1.73 instead of 1.67 in the base case. Thus OECD growth plays an overriding role even with sharply higher interest rates and less dollar depreciation. Our criticism of the exaggerated growth-export earnings assumptions therefore is particularly relevant.

There is uncertainty about the evolution of the monetary-fiscal mix in the United States, but there is now little if any reason to believe that in 1984-1985 LIBOR will show anywhere near the decline predicted by Cline. Therefore, on the macroeconomic assumptions we also differ from the Cline scenario.

### 3. The new IMF projections

Our scepticism of the Cline projections is strongly supported by the recently published IMF, *World Economic Outlook*. 22/ The report sets out a series of scenarios for the world economy in the period 1984-1990 and tests the sensitivity of DC growth and trade performance to changes in interest rates, industrial countries' growth and trade policy.

The basic scenario assumes that industrial countries will grow at the rate of 3.25 per cent for the years 1984-1990 and that LIBOR will decline from the early 1984 level of 10 per cent by three percentage points over the period to 1988. World inflation is assumed to be 4 per cent. A further central assumption is that lenders' exposure is assumed to grow at the rate of 7 per cent thus determining the extent of additional financing or nominal debt growth. Table 14 shows the implied rates of growth of exports, real GDP and the terms of trade for the group of non-oil exporters.

Table 14. The IMF Economic Outlook projection for non-oil DCs  
(Annual average percentage change)

	1983	1984	1985-1987
Industrial countries' growth	2.3	3.6	3.3
Non-oil DC real growth	1.5	3.5	4.6
Export growth	5.3	7.1	5.4
Terms of trade	1.0	1.4	0
LIBOR	9.6	10.0	8.0
Debt-export ratio	149.5	144.7	132.2*

Source: IMF (1984).

\*Debt-export ratio in 1987.

The IMF projections clearly are based on less optimistic assumptions than Cline's about the link between industrial country growth and DC exports: there is no terms-of-trade effect at all, and the volume effect is assumed to be 1.7:1. But even with this much more moderate growth impact, the IMF concludes that the debt problem will, in the baseline case, not get out of hand. Part of the reason for this view is the relatively high, sustained growth of 3.25 per cent in the developed countries. But more so the declining interest rate must account for a significant part of the decline of the debt-export ratio.

Since the interest rate forecasts are already too low for 1984, the optimism of the scenario has to be questioned.

It is worth noting that the baseline IMF forecasts show an improving debt-export ratio. But this is a matter of assumption. Bank lending and hence debt are assumed to grow at only 7 per cent while dollar export earnings, combining volume and inflation, are assumed to grow at almost 10 per cent.<sup>23/</sup> Hence the debt-export ratio must be falling by assumption. The adjusting factor and shock absorber is the non-interest current account and with it, of course, DC growth.

The IMF offers in alternative scenarios an analysis of the sensitivity of the baseline case to changes in growth or in interest rates. Specifically a one percentage point reduction in industrial countries' growth, if no extra financing is available and import contraction becomes necessary, implies that real growth in the non-oil DCs would be reduced by one percentage point every year.

The interest rate-DC growth link is particularly important in view of the sharp (more than 100 basis points) rise in rates that has already occurred since the report appeared in April 1984. IMF calculations (1984, p. 221) show that without extra financing a one percentage point increase in rates requires a reduction in DC growth of one-half percentage point for a year. The shift to a lower level output path generates foreign-exchange saving on the import side to pay the increased debt service. If the outlook now is for an extra 1.5 percentage points above the 10 per cent LIBOR of early 1984, and if there is no compensating compression of spreads or extra financing, a downward revision of the growth rates in table 14 is appropriate. Interest rates then, once more, show themselves to be central to an evaluation of the near-term debt problem.

#### IV. An evaluation of the outlook

In this section we bring together some of the available macro-economic forecasts and use them in conjunction with the empirical relationships discussed earlier to make an assessment of where the debt problem is leading and what it implies for the debtor countries.

##### Forecasts of developed country trends

As we already saw in the discussion of debt scenarios the critical external variables are industrial countries' growth, inflation and nominal interest rates. A number of short-term forecasts dated May to July 1984 are available from official institutions and commercial forecasting firms. Table 15 shows three of these forecasts. The forecasts show average real growth of about 3 per cent for the 1983-1985 period. They coincide in predicting a significant slowdown of growth in 1985, following the strong expansion that has been underway particularly

in the first part of 1984. Available forecasts also coincide in predicting the persistence of low inflation rates in 1984-1985 of around 5-6 per cent. Given the high nominal interest rates, that means high real rates.

Table 15. Forecasts for industrial country growth

	1983	1984	1985
European Communities OECD growth	2.4	4.4	2.6
OECD OECD growth	2.4	4.3	2.8
Data Resources, Inc. (DRI) World GNP growth	2.1	4.0	2.6

Sources: European Communities, OECD (1984), DRI.

Market expectations of the future path of interest rates can be inferred from the term structure of interest. On 21 June 1984 the following rates were quoted for United States Treasury securities: 3 month T-bills at 9.93 per cent, 6 month T-bills at 10.49 per cent, 1-year Treasury securities at 10.87 per cent and 5-year Treasury securities at 13.3 per cent. The term structure is thus clearly upward sloping, reflecting the expectation that future interest rates will exceed current rates. With inflation expectations of about 5-6 per cent, the real interest rate is thus 5-7 per cent, a rate that is exceptionally high by historical standards.

The reason for the high real interest rates remains uncertain. But the most plausible hypothesis is the combination in the United States of tight monetary policy and expansionary fiscal policy, both current and expected. The discussion focuses on the United States economy because the course of United States policy will set the tone for the world economy.

To get a clearer idea of the possibilities we therefore look at the likely evolution of the United States economy. Table 16 shows the detailed July forecast of Data Resources, Inc. for the United States economy under two alternative scenarios. Scenario A is the base case which is assigned a probability of 55 per cent. It assumes some fiscal correction and no outright clash between real growth and monetary tightness. In Scenario B the lack of fiscal correction leads to an overly strong 1984 expansion and, with money unaccommodating to an escalation of interest rates ad 1986 recession. This scenario has a probability of 30 per cent. 24/



Table 16. The DRI forecast for the US economy  
(average annual rates)

	1984		1985		1986	
	A	B	A	B	A	B
Growth	6.5	7.0	2.1	2.3	2.5	-2.6
Inflation	3.7	3.8	4.5	6.3	5.4	6.0
LIBOR	11.2	12.0	12.0	16.1	10.6	14.6
Dollar*	107	108	103	109	96	106

Source: DRI, 28 June 1984 forecast.

\*Index of the effective nominal exchange rate, 1982 = 100. An increase in the index represents a strengthening of the dollar.

The difference between the two scenarios in table 16 points to the critical importance for the developing countries of a move towards fiscal contraction in the United States as the economy reaches full employment. In the recovery from the end of 1982 to 1984, rising interest rates were associated with high growth: DC losses from higher interest rates were to an extent offset by gains from increasing exports. But the difference between scenarios A and B in table 16 has serious implications for the DCs, for in scenario B, United States (and world) growth is lower and interest rates higher than in scenario A. Scenario B does not even provide the consolation of a depreciating dollar, as high interest rates and low-income growth in the United States maintain the exchange rate.

Scenario A shows an average United States growth rate of 3.7 per cent over the years to 1986, compared with 2.2 per cent under scenario B. These rates cover the range of forecasts examined in table 10. The LIBOR interest rate averages 11.2 per cent in scenario A and 14.2 per cent in scenario B. These are well above the forecasts implicit in table 10, but recent experience suggests that higher forecasts are appropriate. We use these ranges of interest rates and growth rates to evaluate the range of outlooks for the DCs.

#### Implications for DCs

We draw attention to three assumptions made by us in evaluating the international debt problem. First, the problem is largely one for the big debtors, primarily but not entirely in Latin America. The rationale

for this view was developed in tables 5, 6 and 7. Further evidence is presented in table 17, which shows the ratio of debt service, and of the interest component, relative to income and GNP for different groups of borrowers. Both in terms of size and in terms of changes the debt burden appears to be very much the problem of large debtors and specifically of Western Hemisphere countries. This matches the evidence we saw earlier in looking at effective interest rates in table 6. We saw there that low-income countries enjoy low effective rates, reflecting a significant share of concessional and fixed-interest debt. Here in table 17 the counterpart is a low and relatively unchanged share of debt service and of interest payments as a fraction of GDP. By contrast the major borrowers show a massive increase in debt service and interest charges relative to their exports of goods and services and relative to their incomes.

Table 17. The debt burden

	Low-income countries		Major borrowers		Western Hemisphere	
	1977	1983	1977	1983	1977	1983
<u>Debt service</u>						
% of exports	12.1	13.3	19.1	29.9	28.2	44.0
% of GDP	1.0	0.7	3.4	6.5	3.9	8.4
<u>Interest payments</u>						
% of exports	4.7	5.4	7.2	18.6	10.0	32.2
% of GDP	0.4	0.5	1.3	4.1	1.4	6.1

Source: Calculated from IMF (1984), tables 36 and 47.

Note: "Major Borrowers" is a Group of 25 DCs defined in IMF (1984, p.159).

Our second assumption is that the problem is one of bank loans, a result of the rapid expansion of commercial bank lending to the DCs in the seventies. The crisis, if there is one, will involve both the commercial banks of developed countries and the large DC debtors. Third, there is no strict economic criterion by which the issue of "solvency" of the debtors can be determined. The issue is much more one of political ability to depress living standards enough to handle the problem - and of the desirability of depressing developing countries' living standards.

We now use the forecasts together with our earlier discussion of empirical growth-export links and of effective interest rates to assess the macro implications for DC countries. Our procedure assumes that external financing constraints limit import volumes and hence growth potential. The IMF (1984, p.160) follows the same procedure and assumes that imports remain the relevant constraint:

"In the present scenario exercise, imports are treated as principally determined by export earnings and the availability of financing. During 1981-1983 the growth rate of imports was constrained by the weak export performance of most developing countries and the shrinking of available financing from international banks. This constraint, although somewhat eased, will to some extent remain in effect during 1985-1987, so that exports plus bank financing were felt to be a better indicator of import growth than developing country GDP ..."

This neglects the potential from DC adjustment policies which we discuss in the next section.

To arrive at the available level of imports we use the basic debt equation (1), noting that  $NX$  is exports less imports of non-interest goods and services. We thus have:

$$(7) \quad \text{Imports} = \text{Exports} + \text{Increase in Exposure} - \text{Interest Payments}$$

In symbols:

$$(8) \quad M_t = X_t + (D_t - D_{t-1}) - i_t D_{t-1}$$

where  $M_t$  is imports,  $X_t$  is exports,  $D_{t-1}$  is the debt at the end of period  $(t-1)$ , and  $i_t$  is the effective interest rate paid on the external debt. The effective rate, as discussed above, is the weighted average of the rates applying to different kinds of debt. From (8) we can go to imports in constant prices by simply dividing by the price level. Equation (8) together with assumptions about inflation, real export growth and the effective interest rate will supply values for real imports. The import numbers in turn can be used to assess the room for growth in output in debtor countries.

Letting  $m_t$  and  $x_t$  denote real imports and exports, and assuming an inflation rate of 6 per cent, we then have 25/:

$$(9) \quad m_t = x_t + RD(.06 - i_t)/(1.06)$$

where  $RD$  is the real value of the debt in the base year which by assumption is to remain constant.

Consider now an application to a hypothetical country that has an initial debt of \$ 100 billion and exports of goods and services equal to \$ 25 billion. In accordance with our emphasis on large-scale debtors, the debt to export ratio is 400 per cent. Base year imports are assumed to be \$ 21 billion. To assess the outlook we look at four possible

combinations of export growth rates and effective interest rates, based on table 16. Table 18 shows the possible scenarios. Using a basic 2:1 relationship between DC real exports and industrialized country growth, and assuming a range of industrialized country growth of 2-3 per cent over the 1983-1986 period, we examine the consequences of real export growth rates of 4 per cent and 6 per cent. For effective interest rates we assume a low 9 per cent and a high of 12 per cent.

The numbers in the body of table 18 represent the average growth rates of real imports in the 1984-1986 period implied by equation (9) and the specified growth and interest rate combinations. The trade-offs are highly significant: an extra point on the interest rate or a percentage point decline in export growth will cost 1.1 to 1.5 percentage points of average import growth. The interesting combination, of course, is a shift from a stable interest rate and growth scenario in the upper right-hand corner to high interest rates and lower growth of exports. Here the cost is more than 6 percentage points of reduced import growth.

Table 18. Import growth under alternative assumptions

	Real export growth	
	4%	6%
Effective interest rate		
9%	6.4%	8.7%
12%	2.0%	5.2%

The final step is to consider the effects of different rates of import growth on DC GNP growth. The IMF (1984, p.221) estimates that a forced 2 percentage point reduction in import growth reduces DC GNP by 1 percentage point. Accordingly the implied range of growth ratio for our hypothetical debtor is 1 per cent per annum to 4.3 per cent per annum.

A growth rate of output of 4.3 per cent is likely to make it possible for our hypothetical debtor country to meet its balance-of-payments goals without reducing living standards to levels that would force a change in policy. But a growth rate of GNP of 1 per cent per annum will not be sustainable. For countries where imports are already depressed relative to output, and where unemployment is high, so low a rate of growth leaves no room for a recovery. There would certainly be no room to absorb a strongly growing labour force. Something would have to give.



The low import and real growth scenario becomes more plausible the more world interest rates rise, and the longer United States fiscal correction is delayed. Failing United States fiscal corrections, there are two ways out. One is the extra efforts debtor countries can make toward achieving growth within the external parameters set by the world economy. The other is to look for debt relief. The remainder of the paper addresses these questions.

Before we leave this section three remarks are in order. First, we have not considered optimistic scenarios - sustained 8 per cent average real export growth and a 5 per cent effective interest rate. If the world turns that way there is no debt problem. But the macroeconomic forecasts that are available give no evidence that such an outlook is plausible.

Second, we have looked at the case where banks are willing to finance a constant real debt. But what would happen if, for the case of countries with severe debt problems (Mexico, Brazil, etc.), banks would seek a reduction in real debt? As equation (9) makes clear the outlook for import growth would be much more confined since now imports must be compressed to retire debt in real terms. More adjustment by debtors or debt relief and freer market access would become even more urgent.

Third, the optimism of the base-case scenarios of 1983, reviewed above, is difficult to sustain, both in terms of the assumptions made then, and even more in terms of the subsequent behaviour of interest rates. There is a serious possibility that the large debtors will be unable to continue to service their debt without further concessions.

#### V. The adjustment effort in debtor countries

The sustainability of the international lending process depends on how long the present adjustment programmes can be continued. Until the world economy leads to strong export growth the debtor countries have to contain domestic demand and employment in an effort to reduce imports and free foreign exchange for debt service. This curtailment in demand coincides and overlaps with the adjustment of public sectors toward leaner and trimmer conditions. The results so far have been dramatic. Trade surpluses have in most cases come out well within the targets of the IMF adjustment programmes; in this sense adjustment has taken place and has been successful. But it is also the case that the trade surpluses have been generated primarily if not exclusively by demand compression and depression, rather than by export growth. The question therefore arises whether these programmes can reasonably be expected to continue and whether they will, in the long run, contribute to a solution of the debt problem.

The rationing of finance, in conjunction with the 1981-1983 world recession and steeply increased interest rates, has visited a depression on developing countries and in particular on Latin America. The

depression of economic activity in that region is already worse than it was in the 1930s. For Latin America the decline in per capita income since 1981 amounts to 12.6 per cent. In Africa, where income was lower to start with, per capita income has fallen by at least 2.5 per cent. To restore the 1980 level of per capita consumption by 1990, growth would need to be significantly faster than the scenarios of the previous sections would lead us to expect. Attention therefore must turn to the way the debt problem tends to depress growth and what kind of adjustment, on the part of the debtor, can improve things.

The debtor countries' problems can be analysed in terms of the ideas of the classical transfer problem. In these terms there are three stages of the transfer problem: the problem of raising fiscal revenue for external debt service; the problem of translating these fiscal resources into potential dollar earnings via import substitution or increased exports under conditions of full employment; and last, securing the foreign-exchange earnings or savings. We now comment on each of these stages in more detail.

The fiscal problem: Consider the case where all external debt is public and hence falls within the government's general fiscal responsibility. The need to service the external debt means that the government budget deficit is thereby increased. Extra taxes must be raised, spending must be curtailed or money creation must finance the deficit.

It is difficult to cope with the domestic fiscal policy aspect of debt in a country where the budget, not counting external debt service, is already in a large deficit. Once no fresh money is available to finance interest charges, the debt service must come at the expense of other programmes or new taxes or else it must lead to more inflation. This is highly controversial because in many instances the debt has been incurred for the benefit of the middle and upper classes whereas the adjustment and servicing costs are borne by the public at large. For example, the debt service might be assured by a cut in public sector wages or in food subsidies. The situation is particularly serious when the debt, as in the case of Argentina for example, has largely been incurred to finance capital flight.

In judging the fiscal effort required to service the debt we have to look at the ratio of debt service to GDP. In the period 1981-1984, according to IMF (1984) data, the ratio of debt service to GDP for non-oil debtor countries was 5.4 per cent. This includes interest and amortization payments. Interest payments alone in that period amounted to 3.3 per cent of GDP. Raising that fraction of GDP in extra taxes or through programme cuts is an enormous task. Total tax collection typically accounts for say 20 per cent of GDP in a DC, and thus this requirement is to cut government spending by 15 per cent or raise revenue by that amount. The difficulty is increased when we consider that the tax structure in many developing countries remains rudimentary and relies strongly on withholding taxes. Taxation of income from capital is often negligible. Financing the debt service then involves in all likelihood yet another severe worsening of income distribution.

This is certainly the case when withholding taxes and subsidy cuts are the chief way for the government to secure revenue for debt service.

The full employment problem: Suppose the government could in fact achieve the fiscal task of raising the revenue for debt service, or could accept the inflationary consequence of deficit finance. The next question is whether the fiscal adjustment can readily be translated into increased export earnings under conditions of full employment. Here the question is how to transfer the resources that are freed by the fiscal correction into increased exports or into replacement of previous imports.

Unless the country is "small" and has the ability to switch resources it will be necessary to change relative prices. Profitability of the traded goods sector must be enhanced, thus creating incentives for the transfer of productive resources in that direction. On the demand side the fiscal tightening directly reduces demand for traded goods thus freeing foreign exchange. But that effect must be reinforced by an increase in the relative price of tradeables that discourages domestic demand. In the terminology of balance-of-payments theory, the expenditure-cutting effect of the fiscal correction must be accompanied by switching policies that move resources and demand into the right place.

The question that inevitably arises is whether these adjustments can be achieved while maintaining employment. More specifically, what are sensible short-run policies that support the fiscal part of the transfer? The conventional argument calls for a real depreciation in order to maintain full employment in the face of higher taxes, reduced subsidies or reduced government demand. But a real depreciation runs into three snags. First, depreciation may not be effective, next it will decidedly be inflationary and third, it will cut real wages and with it, in the short run, employment. We will comment on each of these objections.

The inflation is unavoidable. But unless there are indexation linkages, the inflation shock will be transitory and thus will ultimately represent a minor cost. The cost is only extreme if the corrective devaluation follows after a sequence of already unsuccessful devaluations, or budget corrections, that have produced inflation without a gain in competitiveness. We add that inflation is not the ultimate evil and that reluctance to have a real depreciation may be much more destabilizing for real activity and financial markets than the extra inflation impact of a devaluation. Certainly the uniformly unsuccessful experiences of countries that have tried to stop inflation through overvaluation bear this out very strongly.

The ultimate effectiveness of real depreciation in providing export growth and import substitution is firmly established. One piece of evidence is the devastating effect of overvaluation on the trade balance that we discussed earlier. But we need not go that far. All available



evidence from trade equations supports the view that with a sufficient adjustment time (one year or perhaps as much as 18 months) trade patterns respond strongly to real exchange rates.

There remains the question of how large a contribution devaluation can make to the maintenance of employment. In the Republic of Korea, for example, matters are decidedly favourable. The export sector accounts for 40 per cent of GDP, and trade is strongly responsive to the real exchange rate. In these conditions devaluation provides both relief on the external balance and, at the same time, a direct and substantial boost to output and employment. By contrast, in countries where the export sector is much smaller, devaluation mainly serves as a means of removing the external balance constraint on growth. Supplementary domestic policies are required to bring about a significant expansion of employment.

Real exchange rate adjustment raises the problem of the short-run deflationary effects on output and employment. Before the export expansion and import substitution get under way there is already a cut in real wages. The real wage cut translates into a reduction in spending, a large part of which will fall on domestic goods and services. In the short run a devaluation is likely to create unemployment. This view is firmly established in theory, but there is also supporting empirical evidence. The implication for policy purposes surely is not that devaluation must be avoided. It is rather that devaluation should if possible be accompanied by transitory fiscal policies that sustain employment. One way would be to create public sector projects that have a minimal import content and are labour intensive, i.e. construction. These programmes would be in effect until the output and employment responses are under way to increase demand and employment.

The trade problem: The third aspect of the transfer problem is to assure the effectiveness of the switching policies, translating potential export supply into actual earnings. Here is the problem posed by developed countries, protectionism and by competition among DCs. There is no reason to believe that a much more liberal world trading system is around the corner. Nor is it reasonable to overlook the fact that DCs will be competing with each other in all markets.

There may be limited scope for discriminatory trading arrangements between DCs, such as a Latin American common market. But by and large the assumption must be that the broader-based the export effort, the more likely that it can circumvent commercial policy obstacles in the developed countries and avoid ruinous competition between DCs. A devaluation policy, as opposed to say subsidies for isolated products, thus stands a much better chance of making for an effective export policy.

The recommendation that DCs seek export-led growth raises the system-wide issue of what happens if many DCs try at the same time to



capture markets in the developed countries that are already being increasingly protected. Should we not expect further trade restrictions and would DC terms of trade not deteriorate? The answer to both questions is quite possibly yes. But there are few other ways of maintaining employment. The scope for import substitution, other than in the form of regional arrangements, has been largely exhausted and therefore growth must come from exports. These exports might go to other DCs because increased competitiveness and export orientation makes their products preferable to those of industrial countries. The primary attention should still centre on developed countries' markets. The Asian countries have certainly demonstrated that market penetration is possible even when protection is fierce. We emphasize this point because the absence of costless adjustment often leads to delays in making needed policy changes, thus making the adjustments more costly when they finally occur under crisis conditions.

The long-run outlook also suggests the need for real depreciation. Looking beyond the immediate debt-service difficulties we have to ask how DCs expect to achieve growth in the future. In any plausible scenario, the banks do not increase their exposure by lending more than the interest bill. The international bond market is unlikely to open up for DCs, and there will be no grand aid schemes because the developed countries perceive that they themselves have serious fiscal problems. That leaves foreign direct investment as the only form of external capital. This may be an important supplement to domestic saving, but experience suggests that it will be a very limited one. Accordingly, to provide for growth the export sectors will have to develop much more strongly and much more broadly than has been so far the case. Significant, sustained real depreciation is the best way to bring about such an adjustment.

#### VI. Debt relief and other proposals

A variety of proposals have been offered over the last eighteen months for the solution of the debt problem. These proposals differ widely from grand to cosmetic. They also differ in that some propose to lighten the debt-service burdens on DCs at the expense of banks or the taxpayer, while others are merely concerned to assure with greater certainty that the debts will ultimately be serviced in full. We will review some of these proposals briefly to ask whether by themselves they can make a significant contribution to solving the debt problem. We are thus not questioning desirability.

We will not spend any time on grand schemes. It appears a foregone conclusion that the industrial countries have no inclination whatsoever to create institutions that assume the service of DC debts, for a number of reasons. First, tax dollars are thought of as particularly scarce, too scarce to give either to DCs or to the banks. But there is the additional argument that a bail-out of big debtor DCs would send the wrong signals. It would send the message that overborrowing can be rewarded. Even proposals as modest as providing \$ 2.5 billion extra in Exim-Bank trade credits, or the IMF quota increase have had a very hard time getting accepted.

Defining debt problems: In evaluating debt problems it is important to ask whether we are addressing liquidity problems, solvency or equity issues. Liquidity problems involve an inability to service and amortize debts now on the time schedule initially contracted. There is no question there is a liquidity problem. Equity problems involve the question of how the burden of large, unanticipated increases in the costs of debt service should be borne between lenders and borrowers. Finally, solvency involves the question whether the value of a country's liabilities exceeds the ability to pay. The ability to pay is, as we have argued above, in large measure a political question involving the extent to which activity and standards of living can be depressed to service the debt.

The difference between those alternative views of the debt problem is very important as the following example makes clear. A common recommendation to solve debt problems is the sale of national assets to foreign investors: Brazilian banks or steel mills, Mexican oil wells, Chilean copper mines. The cash receipts would mitigate liquidity problems arising from an unwillingness of banks to lend pending long-term adjustment in the economy that is already underway. Selling assets abroad thus may be an effective substitute for a depression of activity or an over-depreciation. But, as Simonsen (1984a) has pointed out, it reduces the future stream of exports (including net services) and therefore cannot address a solvency problem. It involves even larger difficulties from the equity viewpoint. In the case of selling banks, it may imply an unacceptable transfer of economic control and power abroad.

We have already argued above that the debt problem is mainly one of the major borrowers. Thus with the evidence in table 17 above and the definitions of debt problems arrived at earlier we take the debt problem to be one of liquidity and equity, not solvency, and we take it to be primarily an issue for major borrowing countries. Of course, we do not mean to imply that an African country, for example, that has a small debt, only a small part of which is geared to floating rates, could not experience debt difficulties because its exports have declined sharply. None the less such countries are not those whose difficulties pose the world debt problem.

Some proposals: Having given the debt problem operational definition, we can now look at alternative proposals. Some debt proposals are insignificant in that they involve minor points of debt management that do not address the multi-billion dollar debt-service problem of the DCs. Specific examples are the diversification of the currency denomination of new debts to avoid the concentration of the United States dollar that has so far characterized borrowing and has proven a costly mistake in the 1979-1983 dollar appreciation. Another proposal along the same lines draws attention to interest-rate swaps that would allow DCs a departure from floating rates. Of course, the swaps will be done implicitly at the anticipated future rates and therefore do not get away from the chief problem, namely that interest rates are high and expected to rise. Yet another proposal addresses the difficulties of rescheduling debts by suggesting that small banks be bought out. It is

hoped that with fewer and larger banks involved in the rescheduling there is more scope for differentiation between borrowers and in particular more room for using both the carrot and the stick.

Three specific proposals merit attention. The first of these is a new SDR allocation proposed some time ago by the Group of 24 and more recently by John Williamson (1984). The case for a new SDR allocation rests on the fact that international reserves are low relative to world trade and that therefore the perception of reserve shortage leads to unnecessarily restrictive policies. The case is reinforced when reserves are measured not, as is customary, relative to world merchandise trade but rather relative to world trade in goods and services. By this more appropriate measure, the inadequacy of reserves is much more pronounced. The case is strengthened by taking into account the effect of increased variability of the value of trade in goods and services. A new SDR allocation is clearly a desirable measure. But it must also be clear that it is not a solution to the debt problem, neither for large nor for small debtors. If the SDRs are used to pay off debts, the reserve inadequacy problem remains. If they are not used, the debt problem remains. This is none the less an opportune time to present a case that clearly stands on its own merits.

A quantitatively more important proposal is to extend in a big way the role of the World Bank. World Bank ability to borrow in world markets would be increased. The World Bank would use the increased resources to provide DCs with leverage in borrowing. The good experience with World Bank lending in this respect makes this one of the important long-run steps.

The third measure is a call for an IMF interest rate facility. (See Dornbusch (1983)). Currently the IMF provides financial accommodation to countries that experience a temporary decline in export earnings. It is natural to extend this shock-absorber facility to interest-rate rises, which are as much of an external shock for some debtor countries as are commodity price fluctuations for primary commodity exporters. Organized as a revolving fund such a facility would play an important role in helping debtor countries withstand interest-rate shocks.

How far can such an interest-rate facility (IRF) go in coping with debt-service difficulties? At present a one percentage point increase in interest rates increases debt service by all DCs by approximately US \$ 5 billion. But increases have in the last half year already been larger than one-and-a-half per cent and are expected to last for two or even three years. As a shock absorber the facility can thus cope at best with part of the liquidity problems posed by interest-rate escalation unless the fund is of the order of \$ 10 billion or even more. Whatever quantitative contribution the IRF can make, there is no doubt that on analytical grounds such a facility has the same justification and merit as a compensatory facility for export fluctuations.

Another direction in which institutional change should be pressed



very urgently concerns external assets of the nationals of debtor countries. It is a well-established fact that a significant part of the external debt of Mexico or Argentina, for example, has as a counterpart holdings of assets by nationals of these countries in the industrialized world. These holdings may be real estate, securities or bank accounts. The fact that they are not available to help finance debt service severely aggravates external and fiscal adjustment problems. It is natural to go from there to recommend that industrial countries offer assistance to debtor DCs in gaining information on those assets and on the incomes they yield. This is a routine procedure among the revenue services of many industrial countries and it is entirely appropriate that it should be extended to debtor DCs. Viewed in this perspective the United States proposal for the abolition of withholding taxes on non-residents appears an open invitation for more capital flight from debtor DCs rather than a step in the direction of supporting DCs in marshalling equitably resources to service their debts.

The cap: The central proposal in coping with the liquidity and equity problems posed by present levels of interest rates is the idea of an interest rate cap. The cap idea comes in three variants. An outright concessional cap (con-cap) would place a ceiling at say 7 per cent and forgive any excess of market interest rates over that ceiling indefinitely. A second form, at the other extreme, would also set a ceiling but, rather than forgiving the difference between market rates and the ceiling, would add the difference to the principal of the debt. This is a liquidity-cap since it copes chiefly with the liquidity problems posed by interest-rate increases. The third kind, which we advocate and develop in more detail below, involves both concessional and liquidity aspects and thus is an intermediate variant.

The con-cap amounts to a dramatic rewriting of debts that implies a massive capital loss for the banks. Taking only the loans to DCs by financial institutions and assuming that over the next seven years interest rates decline from 14 per cent to the 7 per cent level of the cap, the total reduction in the present value of these debts would be about \$ 100 billion or close to 30 per cent. If the loss were not absorbed by taxpayers it would imply the bankruptcy of major banks in the United States and in other countries. Because the proposal goes beyond taking losses to the almost certain bankruptcy of some major United States banks, it is unreasonable to assume that banks should choose to accept such a proposal or that governments should find it attractive to legislate it. This is all the more the case in that it involves a redistribution from creditors to many countries who experience debt-service difficulties that are by no means extreme.

As the outcome of a negotiation a 7 per cent cap seems implausible. But, of course, if debtors were well-organized this might well represent a unilateral proposal that some particular group might advance. As such it is not out of line. It is often argued that any unilateral move to rewrite the debt would have dramatic implications for that country's future access to the lending by banks. But fresh lending of more than a part of the interest bill is in any case unlikely over the next few years. Banks are reducing exposure or the relative proposition of DC



debts in their portfolios and hence the prospect of ample future financing as a counterpart of current faithful debt service is in no way assured.

At the other extreme of the con-cap is the liquidity cap proposal. This proposal envisages stretching maturities and capitalizing all interest payments above a cap level of say 10 per cent. It starts from the realistic recognition that DC borrowing in the past was based on the presumption of rolling over the principal and capitalizing interest by fresh loans. The credit rationing that has taken place since 1982-1983 has changed these rules, but with enough adjustment having been achieved and/or initiated it is time now to return to this former pattern. Accordingly, it is argued that the amortization component of debt service should automatically be rescheduled in a long-term fashion. Debts maturing now would be renewed to become due ten years hence. This first part of the proposal copes with the problem of a debt service hump, a bunching of debt service due to simultaneously high interest and amortization payments.

The proposal goes further to argue that because real interest rates are transitorily high, there should be an arrangement that copes with the resulting liquidity problem. Rather than forcing debtors into unreasonably steep depression of activity to marshall debt service dollars, part of the increased interest bill would be automatically lent and added to the principal. For banks the proposal is of interest because it removes the debtors' liquidity problems as a potential source of default temptation. It has the further advantage that it precludes the bank free-rider problem in the rescheduling process. At present when loans are rescheduled some banks do not participate which implies that they reduce their exposure to the debtor country, with other banks having correspondingly to increase their exposures. If the liquidity cap were automatic with respect to amortization and interest, all initial lenders would be participating in the capitalization of above cap interest and in the stretching of maturities.

From the debtor point of view the liquidity cap proposal offers little attraction beyond the current rescheduling process. The rescheduling process would become more automatic and some of the crisis features would be removed, but there would be no real gains. Specifically interest not paid today would be paid, with interest, tomorrow or the day after tomorrow. It is primarily a proposal to make the creditor cartel more operational. The problem for debtor countries is apparent when we look at a high interest period. Suppose, as discussed above, that over the next three years the effective interest rate averages 13 per cent and the growth of export earnings is only 10 per cent. Over a three-year period, with a balanced non-interest current account, the debt-export ratio would rise by 8.4 per cent. The liquidity problem would be solved but the debt burden would rise. The liquidity cap thus amounts to giving DC debtors a credit card, not debt relief.

Our own proposal deals with rescheduling of principal and with the

problems posed by presently high interest rates. With respect to the problem posed by a bunching of amortization, we see a need for an automatic stretching of debts to a much longer maturity, at least ten years. The fact that debtors have run into an unanticipated problem of record interest rates and poor export earnings should not lead to an extra burden of the amortization of debts that normally would have been rolled over automatically. On the contrary, the extra burden of debtors needs to be avoided by requiring lenders to maintain their exposure in respect to principal.

But there also needs to be an arrangement to cope with the difficulties posed for some countries by temporarily high interest rates. We recommend a 9-10 per cent ceiling on interest rates, the difference between market rates and the ceiling entirely forgiven (rather than capitalized), during a three-year grace period. Clearly this cap amounts to a transfer from the creditor banks to the debtor DCs. The capital loss on outstanding loans would be 9-11 per cent. The loss is significant but falls short of creating conditions of bankruptcy.

However, we do not believe that the interest ceiling should be available unconditionally to all debtors, DC debtors, non-oil DC debtors or any broadly defined group. Rather we believe it should be rationed to those countries genuinely in need and undergoing adjustment. For that reason we recommend that access to the cap be limited to countries that are accepting an IMF stand-by agreement. Specifically we recommend that to make the proposal directly operational and remove it from the discretion of banks, member countries should instruct the IMF not to sign agreements unless a prior cap agreement has been secured from the banks. This procedure forces the IMF to change its procedures in two respects. The IMF will have to require limited debt relief rather than merely manage the liquidity feature of the debt problem. Second, the IMF will have to give much more emphasis to making countries, in the medium term, look toward growth and debt servicing. This represents an important change from the current concentration on inflation and budget cutting.

Our proposal appears very limited: temporary, limited debt relief for a selected group of countries in sufficient trouble that they must seek an IMF stand-by agreement. But the proposal has the advantage of being completely operational. There is no direct call on taxpayers' money, there is no need for banks to agree and there is no recommendation that would imply wiping out the ten major banks in the world. The emphasis is on keeping countries in severe difficulties sheltered from the extra damage that comes from the currently high rates. But the principal advantage of the proposal is to get around the present deadlock between banks and debtors. Governments of industrialized countries have quite explicitly taken a liquidity view of the problem. They have, directly or through the IMF, supported the integrity of existing debts at market rates plus fees and spreads, by creating facilities for rolling, bridging and capitalizing. It is time now to recognize that there is also an equity issue. Governments, via instructions to the IMF should throw their weight more in the direction of borrowers by seeking a limited, responsible debt relief for countries particularly burdened by debt service at current rates.

There is an extra feature worth pointing out. Our scheme for debt relief invokes a transfer from banks to debtors. It involves only a limited and indirect participation of the taxpayer. We see that as an essential feature. The contribution is limited to the reduction in income taxes, corporate and personal, arising from reduced earnings of banks. The fact that the taxpayer contribution is indirect and limited implies that there is no direct threat to concessional resource flows to countries that are not beneficiaries of debt relief because they never acquired significant bank debt in the first place. A proposal that would go much further than the one we advance would inevitably draw in tax dollars in a major, overt way and therefore almost certainly lead to some and perhaps even large offsetting reductions in concessional lending or other forms of resources made available to the lower-income DCs. Our proposal therefore does recognize that the debt problem is not a generalized DC problem and that an imprudent solution worsens the distribution within the DC countries.

A word of caution is needed. Our proposal for limited debt relief is based on the assumption that interest-rate problems are strictly temporary. Specifically, we assume that over a ten-year period growth of export earnings will comfortably exceed the effective rate of interest. That does assume a more reasonable monetary-fiscal policy mix and growth in industrial countries, and it assumes no further restrictions on the exports of debtor countries. If either assumption is incorrect, debtor countries will have to take a dramatically different view of their debts.

This point has been put in a particularly forceful manner by Simonsen (1984b, p.41):

"To keep developing debtor countries co-operating with the international financial community, a basic question should be addressed: under what conditions rational policy makers in debtor nations would prefer co-operation to retaliation? While precise rupture points are difficult to locate, a general principle remains valid: a growing economy with expanding exports hardly would seek confrontation with its creditors. In the same line, solvency at the expense of prolonged recession may be politically unsustainable."

## FOOTNOTES

1. See Dragoslav Avramovic et al. Economic Growth and External Debt, Johns Hopkins Press, 1964, and Bahram Nowzad and Richard Williams: External Indebtedness of Developing Countries, Occasional Paper no.3, International Monetary Fund, 1981.
2. Such summary measures are bound to be needed when the complex question of debt capacity, for which the theory is still extremely rudimentary and the financial stakes large, is at issue. For analysis of optimal borrowing, see Pranab K. Bardhan, "Optimum Foreign Borrowing", in Karl Shell (ed), Essays on the Theory of Optimal Economic Growth, MIT Press, 1967, and Olivier J. Blanchard, "Debt and the Current Account Deficit in Brazil", in Pedro Aspe Armella et al (eds), Financial Policies and the World Capital Market: The Problem of Latin American Countries, University of Chicago Press, 1983.
3. For details of interest rates charged DCs, see E. Brau and R.C. Williams et al, "Recent multilateral debt restructuring with official and bank creditors", IMF Occasional Paper no. 25, December 1983.
4. Of course, the debt data of the 1920s and 1930s might be no better than those we have today.
5. The real debt is larger than the nominal debt after 1980 because the export unit values of industrialized countries fell from 1980 to 1983.
6. The interest cost measures in table 6 give some guidance to the differences in debt service costs between countries. But the data must be interpreted with caution for two reasons. First the 1982-1983 estimates may be distorted by arrears. Second, estimates of the stocks of debt outstanding remain very tentative even today.
7. Although we consider the question wide open we show here the typical result for the 1958-1982 period. DINDGrowth here represents the one period lagged change in industrial countries' real growth.  

$$\begin{array}{lcl} \text{Growth of real} & = & -.012 + 1.3 \text{ DINDGrowth} \quad \bar{R}^2 = 0.29 \quad \text{DW} = 2.14 \\ \text{export price} & & (-.015) \quad (3.27) \end{array}$$
 Unlike Cline (1984), we did not find a significant impact of the current change in growth.
8. On this point see, too, Goldstein and Khan (1982). The IMF (1984) World Economic Outlook uses a relation between export revenue growth and industrial country growth of 1.7.
9. The example of Argentina, Chile, Brazil and Mexico are examined in detail in Dornbusch (1984a).
10. One Mexican case is particularly well-documented in studies by L. Solis and E. Zedillo (1984) and P. Aspe and J. Cordoba (1984).



11. Dornbusch (1984a) shows that the same distinction is important in the Argentinian case.
12. See Federal Reserve Bulletin, March 1984 Table 3.17 and Bank for International Settlements, International Banking Developments, Fourth Quarter 1983 and International Banking Statistics, 1973-83.
13. Economic Report of the President, 1984, p. 78.
14. William R. Cline, International Debt and the Stability of the World Economy, Institute for International Economics, Washington, D.C., 1983, p. 121.
15. Thomas O. Enders and Richard P. Mattione, "Latin America: the Crisis of Debt and Growth", Brookings Discussion Papers in International Economics, No.9, December 1983, p. 2.
16. To derive (5) note that  $D_t = D_{t-1} + CD_t$  or  $D_t(1 - cd_t) = D_{t-1}$  where  $CD_t$  is the current account deficit. For the debt-export ratio to decline over time the coefficient  $1/(1+gx_t)(1-cd_t)$  must be less than 1. This condition is ensured if  $cd < gx/(1-gx)$ , i.e. the deficit ratio must be small relative to the growth rate of export earnings.
17. Dooley et al assume that the countries in their sample will meet the IMF's prescribed goals, which result in a balanced non-interest current account over the period.
18. The Morgan Guaranty World Financial Markets (June 1983) notes a debt-export ratio of 1.6 as a signal of a greater likelihood of debt rescheduling; every country with a ratio above 2.0 has at some time been forced to reschedule. McFadden et al (1984) find high debt-export ratios a consistently significant prediction of defaults.
19. We have omitted a further term that stems from real depreciation in the debtor countries. The omission does not have a bearing on the comments offered here.
20. The assumptions or evidence in Dooley et al (1983), IMF (1983, 1984), Morgan (1983), Goldstein and Khan (1982), and Khan and Knight (1983), all support the view that the cyclical elasticity is two or less. Goldstein and Khan point to increased intra-DC trade, in particular involving oil producers, as an important source of increased DC trade growth in the 1970s.
21. The Central Bank of Brazil (1984, p.55) reports that 80 per cent of the external debt service is based on a variable rate. The ratio of variable interest debt to exports for Brazil is equal to 3.0.
22. See IMF, World Economic Outlook, Occasional Paper No. 27, April 1984, especially chapter 4.
23. See IMF (1984), p. 21, Chapter IV, and pp. 157-162.
24. There is a further scenario that involves optimism.

25. To derive (9), divide in (8) by  $P_t$ , obtaining

$$\frac{M_t}{P_t} = \frac{X_t}{P_t} + \frac{D_t}{P_t} - \frac{D_{t-1}}{P_t} - \frac{i_t D_{t-1}}{P_t}$$

$$\text{Then } m_t = x_t + \frac{D_t}{P_t} - \frac{D_{t-1}}{P_{t-1}} (1+i_t) \left( \frac{P_{t-1}}{P_t} \right)$$

With the real debt constant at RD and  $P_t/P_{t-1} = 1.06$ , we obtain (9).

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BALANCE OF PAYMENTS EXPERIENCE AND GROWTH PROSPECTS  
OF DEVELOPING COUNTRIES

A SYNTHESIS

G.K. Helleiner\*

PREFACE

The present report is one of a series of studies prepared under the joint sponsorship of the United Nations Development Programme (UNDP) and the United Nations Conference on Trade and Development (UNCTAD). The studies are designed to be of assistance to the Intergovernmental Group of Twenty-Four in dealing with various problems of concern to the Group in the field of international monetary and financial arrangements.

An earlier study in the series, entitled "The Balance of Payments Adjustment Process in Developing Countries", published in January 1979, dealt with the problems faced by developing countries during the 1970s in adjusting their economies to the first oil crisis. It was felt that the time had come to return to this subject in the light of the further external shocks that have occurred more recently. The present study therefore brings the earlier report up to date by reviewing experience during the ten-year period ending in 1984. Like the previous report, the present study bases itself, *inter alia*, on a number of case studies. The countries selected for this purpose - partly in the light of availability of data - were Brazil, India, Ivory Coast, Mexico, Philippines, Republic of Korea, Zimbabwe.

The studies were conducted by highly qualified experts, mostly nationals of the countries concerned. Some of the authors have been or still are in the service of the government or of the central bank of the country studied by them. The views expressed in the studies are those of the authors and do not necessarily reflect those of the governments concerned or those of the secretariat of UNDP or UNCTAD.

The studies are presented in the alphabetical order of these countries and are issued as addenda to the present document. This document constitutes a "synthesis" in which Professor G.K. Helleiner sums up the conclusions that may be drawn from the country studies and from other material dealing with this subject.

The designations employed and the presentation of the material in this document and its addenda do not imply the expression of any opinion on the part of the secretariat of UNDP or UNCTAD concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

## 1. INTRODUCTION

During the past decade the developing countries have been buffeted by a series of severe external shocks - oil price increases, global price inflation, recessions, high interest rates and exchange rate instability, and, most recently, interruption of supplies of accustomed external finance. From 1979 onwards they were hit by the longest and most severe recession since the Second World War and then by unprecedented increases in interest rates, appreciation of the U.S. dollar (in which most of their external debt is denominated), low prices for their export commodities (other than petroleum) and, from mid-1982 on, sharp reductions in the inflow of commercial capital.

A recent IMF staff study places the recent experience in a longer-term context:

"During 1981-82, commodity prices declined further (25 per cent) and for a longer period (8 quarters) than they have in the last three decades. In 1981, real commodity prices reached a postwar low, and in 1982, they declined a further 11 per cent, to a level 16 per cent below the trough reached in the 1975 recession... The sharp decline in commodity prices during 1981-82 is ... a culmination of a trend toward more unstable prices that began in the early 1970s. The long-term downward trend in real commodity prices from 1972 to 1982 has been more than twice the trend from 1957 to 1971. In addition, primary commodity prices during 1972-82 were more than three times as unstable as they were during 1957-71, while fluctuations in world economic activity, exchange rates, and interest rates were significantly more pronounced in 1972-82 than in 1957-71" (Chu and Morrison, 1984, pp. 126-27).

As a consequence, the economic growth of most developing countries has been interrupted and per capita income in many of them has declined. According to the IMF, the average growth in output of developing countries (weighted by economic size) was minuscule during the 1979-1983 period. As Table 1 shows, the performance was particularly bleak in 1982 and 1983, above all in Africa and the Western hemisphere.

The impact of the post-1978 events can also be gauged from country-level macro-economic data for a broad sample of developing countries available in standard international sources. Table 2 shows that low-income, lower-middle income, and middle-income oil-importing countries (World Bank classifications) suffered declines in import volume while GDP increased in many cases at a rate barely sufficient to keep pace with population growth. Gross capital formation fared a little better in the low-income countries, implying relatively worse experience for consumers, but otherwise grew at roughly the same low rates as GDP. These median data obviously conceal experiences that vary from country to country and over time within the period. They also understate the extent of the decline in macro-economic performance since for some countries the most recent available data were those of 1979 or 1980, and the situation thereafter took a marked turn for the worse. Nevertheless, they indicate the breadth of recent prolonged experience with stagnation in investment and import decline, both of which, whatever happens in the next few years, are bound to affect medium-term growth. First-quarter 1984 data

Table 1Annual percentage change in output in developing countries, 1978-1983\*

	Change from preceding year				
	1979	1980	1981	1982	1983
All developing countries	4.8	3.5	1.2	0.2	0.8
Non-oil developing countries	5.1	5.0	2.8	1.5	1.6
<u>By analytical group:</u>					
Net oil exporters	7.6	7.3	6.6	1.1	-1.5
Net oil importers	4.7	4.7	2.2	1.6	2.2
of which:					
Major exporters of manufactures	6.4	4.5	0.1	0.3	-0.1
Low-income	3.3	6.0	4.3	4.3	6.1
Excluding China and India	2.3	3.4	3.4	3.8	2.6
Other net oil importers	3.6	3.2	3.1	0.4	1.1
<u>By area:**</u>					
Africa (excluding South Africa)	2.2	3.0	1.8	1.2	0.1
Asia	4.7	5.4	5.1	4.5	6.5
Western Hemisphere	6.7	6.1	0.2	-1.6	-2.3

Source: IMF, World Economic Outlook, 1984a, p. 170.

\* Arithmetic average of country growth rates weighted by the average US dollar value of GDPs over the preceding three years.

\*\* Europe and Middle East not shown.



Table 2

Macro-economic indicators, 79 developing countries\*  
1978 to 1981-1982

Medians for the following groups of countries	Average annual percentage change in		
	Constant Price GDP	Constant Price Gross Capital Formation	Import Volume
Low-income (29)	+2.8	+3.9	-4.2 (20)
Lower middle-income (34)	+3.2	+3.0	-1.9 (28)
Upper middle-income (15)	+4.5	+6.6	+1.4 (13)
Middle-income oil importers (34)	+3.2	+3.6	-2.2 (28)
Middle-income oil exporters (16)	+5.7	+6.8	+6.4 (14)

Source: Calculated as simple averages of annual change from 1978 to the latest year for which data were available: 1981 or 1982 in the case of GDP, 1979 to 1982 in the cases of capital formation and import volume.

World Bank, World Tables, 1983.

IMF, International Financial Statistics, Annual, 1983.

\* Number of countries for which there are data is shown in brackets.

indicate a continuing decline in the imports of non-oil developing countries, particularly those of the Western Hemisphere.

Massive arrears on external payments, necessitating partial or total suspension of debt servicing and a host of ad hoc official and private rescheduling arrangements, have characterized their international financial relationships since 1982. The former net flow of resources from the industrialized to the developing countries has now been reversed, as interest payments on accumulated external debt exceed net new inflows of foreign capital. Emergency financing for a few large debtors, including continuing "involuntary" lending by commercial banks, has postponed the realization of the current account surpluses (but, because interest must still be paid, usually not the trade surpluses) that would otherwise be implicit for these developing countries in current global conditions; there is none the less heavy pressure from creditors to restore "normal" arrangements as quickly as possible.

Table 3 presents the World Bank's estimates of the main elements in the financing of the developing countries' aggregate current account deficits during the 1980-1983 period. It shows clearly the sharp contraction in the flow of private capital to the oil-importing developing countries from 1981 onwards, the modest decline in official finance during the same period, and the increase in interest payments on debt. These changes made it necessary for the developing countries to realize substantial improvements in their net exports of goods and non-factor services in a very short space of time.

It would be misleading to attribute all of today's domestic stagnation, inflation and external imbalance within the developing countries to global influences. The developing countries themselves are also responsible for some of their balance-of-payments and macro-economic difficulties. The relative importance of external and domestic influences upon the macro-economic experience of developing countries in recent years obviously varies greatly from country to country; and it is equally obviously a matter of intense controversy. Mutual interaction and cumulative processes frequently render it difficult clearly to disentangle the separate impacts of these influences. There is no disagreement, however, with the proposition that severe external shocks have imparted heavy blows to the balance of payments and growth, and created difficult problems of macro-economic management, for all of the non-oil developing countries.

A recent IMF staff study finds that the single most important variable "explaining" recent experience with current account imbalances in 32 non-oil developing countries in the 1973-1980 period is that of the terms of trade (Khan and Knight, 1983, p.835). Foreign real interest rates and the rate of growth of industrial countries are also found to be significant influences upon the current accounts of the developing countries concerned. (Presumably these results would be strengthened by the use of later data.) But the same study also finds that variables representing domestic policy - in particular the real effective exchange rate and the government's fiscal position (revenues minus expenditures) relative to GDP - are of significance. The authors conclude that "at least some portion of the current account effects of adverse international developments could be offset by a combination of a more

Table 3

Current account balance and its financing, 1970-1983  
(Billions of current dollars)

COUNTRY GROUP AND ITEM	1970	1980	1981	1982	1983 <sup>a/</sup>
<b>Developing countries</b>					
Net exports of goods and non-factor services	-9.8	-55.2	-80.5	-57.1	-10.9
Net factor income	-3.6	-16.4	-30.0	-43.2	-48.3
Interest payments on medium- and long-term loans	-2.7	-32.7	-41.2	-48.4	-49.0
Current account (excludes official transfers) <sup>b/</sup>	-12.7	-69.6	-107.8	-97.6	-56.2
Financing					
Official transfers	2.4	11.6	11.7	10.8	11.1
Medium- and long-term loans					
Official	3.7	21.5	21.2	21.4	17.6
Private	4.6	35.7	49.6	33.5	39.9
<b>Oil importers</b>					
Net exports of goods and non-factor services	-8.9	-69.3	-70.5	-46.9	-26.0
Net factor income	-1.5	-14.3	-14.4	-21.8	-25.0
Interest payments on medium- and long-term loans	-2.0	-23.3	-26.7	-31.7	-32.3
Current account (excludes official transfers)	-9.8	-70.3	-81.8	-65.6	-46.1
Financing					
Official transfers	1.8	9.6	9.4	9.0	8.9
Medium- and long-term loans					
Official	2.9	16.9	16.5	15.9	13.9
Private	3.7	24.6	30.8	22.0	11.1
<b>Oil exporters</b>					
Net exports of goods and non-factor services	-0.9	14.2	-10.0	-10.1	15.1
Net factor income	-2.1	-12.1	-15.6	-21.4	-25.8
Interest payments on medium- and long-term loans	-0.7	-11.5	-14.5	-16.7	-16.7
Current account (excludes official transfers)	-2.9	1.7	-26.1	-32.1	-10.0
Financing					
Official transfers	0.6	2.2	2.3	1.8	2.2
Medium- and long-term loans					
Official	0.8	4.6	4.7	5.5	3.6
Private	0.9	11.1	18.8	11.6	28.9

Source: World Bank, *World Development Report*, 1984, p.30.

Note: Calculations are based on a sample of 90 developing countries.

a/ Estimated.

b/ Current account does not equal net exports plus net factor income due to omission of private transfers.  
Financing does not equal current account because of omission of direct foreign investment, other capital, and changes in reserves.

flexible exchange rate policy and tighter demand management policies" (pp. 838-9). The feasibility and efficacy of such policies in the particular contexts of individual countries obviously vary and must be a matter for much more careful investigation.

While recovery from the most recent recession is now under way, particularly in the United States and Japan, projections of global growth remain cautious, real interest rates remain high, the terms of trade in most developing countries have not recouped recent losses, and protectionist pressures continue to restrain growth in export volume. Moreover, in the remainder of the 1980s and perhaps in the 1990s as well, the world economy looks like being far more unstable and its performance more uncertain than in the 1950s and 1960s.

The research summarized in this paper was undertaken to shed light upon the medium-term implications for the developing countries and for the international financial system as a whole of the massive shocks imparted to the balance of payments of the majority of developing countries during the 1979-1983 period. It was obviously not possible in the time and with the resources available to undertake a comprehensive examination of these issues. What was attempted instead was the application of a uniform research methodology, within fairly broad guidelines, to a relatively small number of developing countries. Analysts undertook to summarize the macro-economic experience of selected developing countries since the early 1970s, with particular emphasis upon the 1979-82 period; to document the importance of external shocks and adjustment needs; to assess recent efforts at balance of payments adjustment; and to evaluate these countries' medium-term growth prospects in the context of alternative national and international scenarios.

The countries were chosen partly for their importance in the international economy and partly to show the great variety of experience in the developing countries in recent years. Each country's experience is, of course, unique; but each can nevertheless be instructive to others.

Mexico's experience with macro-economic management in the context of new resource (oil) discoveries and access to large-scale external borrowing, followed by a "crisis" of world-scale importance and strenuous efforts to restore external balance, must be of interest to the world's entire financial community. Similarly, the Indian and Brazilian experiences (though not directly replicable in many developing countries) are of equally widespread interest because of the sheer size of these two economies. Brazil is also, of course, the largest debtor among developing countries. The growth story of the Republic of Korea is well-known but its behaviour in the face of severe external shocks in recent years, no less interesting and potentially instructive, deserves more attention. In the Philippines in recent years political events have received more attention than have its macro-economic experience and prospects; the case of the Philippines illustrates graphically some of the risks inherent in massive external borrowing and the need for domestic restructuring even in countries with apparently fairly easy access to external credit. The African cases (Ivory Coast and Zimbabwe) are noteworthy for their demonstrations of the influence of the weather on macro-economic performance and management. The case of Zimbabwe is obviously considerably



further complicated by major political events - civil war, the attainment of independence, cessation of international sanctions, etc.; our Zimbabwe study is among the first to assess recent macro-economic performance and prospects in this potentially important and relatively developed new member of the African community. The Ivory Coast represents the best growth performance in the currently stagnant and suffering African continent; unlike many other African countries, Ivory Coast accumulated substantial debt during the 1970s. Unfortunately, the scarcity of data limited the analyst's capacity to undertake an analysis comparable to those of the other countries in the sample.

Brazil, India and Mexico have negotiated by far the largest of the extended arrangements entered into by the IMF with developing countries in recent years. (The Indian agreement has now been terminated by mutual agreement.) Brazil and Mexico are among only four countries now enjoying an extended IMF arrangement, and they account for over 90 per cent of agreed and undrawn such credits. The standby agreement of the Republic of Korea is at present the largest outstanding with the IMF. The Philippines is now discussing a standby of about the same size as the Republic of Korea's. Zimbabwe and the Sudan both also have IMF standby agreements outstanding. The Ivory Coast, the Republic of Korea and the Philippines were all recipients of World Bank structural adjustment loans in 1980/81, each renewed and expanded in 1983.

Under-represented in this sample are the very poor and very small countries - those that have had extremely limited access to external commercial finance, that are heavily dependent upon concessional flows, and that dominate the lists of the "least developed", "poorest", or "low-income" countries. The only country in the World Bank's "low-income" category (GNP per capita of under \$410 in 1982) in our sample is India.

Some attempts were made to expand the coverage of the studies by using internationally available data rather than in-depth country-level analysis. As is always the case in such "library" investigations, country coverage was determined purely by the accessibility of data.

It is well-known that the economic data for sub-Saharan African countries are particularly weak. It has unfortunately not been possible to incorporate as thorough an empirical analysis as this area's macro-economic problems, on grounds of humanitarian concern, undoubtedly deserve. Such data as there are suggest that the external shocks imposed upon the typical African country, overwhelmingly the product of terms-of-trade deterioration, have been severe and that total external finance has not expanded in response to the crises of the 1970s and 1980s. The structural adjustment capacities of these countries are almost certainly more limited than those of other developing countries.

Per capita income has been falling drastically in low-income Africa in recent years. Investment programmes have been savagely slashed and the high rates of depreciation of buildings and physical machinery and equipment in African conditions imply that the usable capital stock is, in many areas, actually declining. The consequential deterioration of medical, health and educational facilities probably implies a further deterioration of human resources, in addition to the obvious decline of the quality of life.

Short- to medium-term prospects for Africa are exceptionally bleak.

"Even under relatively optimistic assumptions about the speed and magnitude of the economic recovery in the OECD area, the prices of relatively few of the export commodities of African countries are expected to show increases in real terms. Altogether, the average price level in the 1980s is expected to remain about 15-20 per cent below that prevailing in the 1960s or the level obtained in the second half of the 1970s." (World Bank, 1983, p.3).

Imperfections of data must not lead the international community to neglect the grave circumstances in Africa.

This "synthesis" is organized as follows. Section 2 discusses, in general terms, the impact of external shocks, possible responses to them and alternative ways of analyzing these phenomena. In Section 3 the results of an empirical analysis of recent external shocks and policy responses in 25 countries are reported; an appendix to the section reports on previous research of the same general type carried out by others. Section 4 introduces the methodology and assumptions behind subsequently reported country-level projections to 1989. A summary of six of the detailed country-level analyses is presented in Section 5. An overall summary and conclusions in a final section complete the paper.

## 2. ALTERNATIVE APPROACHES TO THE ANALYSIS OF EXTERNAL SHOCKS AND RESPONSES TO THEM

External shocks of the kinds described above - terms-of-trade deterioration, reduced demand for exports, international interest-rate increases - reduce national income directly by reducing demand and/or the purchasing power of existing output. Even if total national output were to be sustained, painful cuts in income would have to be borne - distributed in ways which are the product of the nature of the shock, the characteristics of the economy, and governmental policy responses. In terms of the conventional macro-economic accounting variables either real national consumption or real national savings (or both) must fall. Other things being equal, a reduction in national savings will reduce real investment and thereby cut future output (and real income) as well. Real investment can only be sustained if the national savings rate (i.e. savings as a proportion of national income) rises or if increased resources can be obtained from the rest of the world. Similarly, real consumption can only be sustained if the savings rate declines or increased external resources are available. Sufficient external resources thus make it possible to keep both real consumption and investment at pre-shock levels. If the shock is expected to be a temporary one, there is a strong case, recognized in IMF practices, for making finance available for that purpose, so that policymakers will not be tempted needlessly to resort to "measures destructive of national or international prosperity" (IMF, Articles of Agreement, I(e)).

External shocks that permanently alter the terms on which individual countries interact with the international economy require that "adjustments" be made if previous projections as to levels of consumption, investment and

income are to be realized in the medium to longer-term. There is no internationally recognized presumption in this case that finance will be made available to ease the effects of such shocks, since, in the absence of sufficient adjustment, the new finance would have to be provided on a permanent basis. There is widespread intellectual support and even some precedent in multilateral lending, however, for the provision of credit to ease the costs of necessary adjustments (Williamson, 1983).

External finance can thus be an important, even a crucially important, determinant of the impact that external shocks have upon national macro-economic performance. On the other hand, interruption of the "normal" flow of external finance can itself be another source of external shock to the national economy.

These direct effects of external shocks are those that typically occupy most of analytical attention. But they are not the only possible effects. Output may fall below or further below the economy's capacity to produce, in consequence of a dearth of essential inputs that, at least in the short run, can only be obtained via imports. Foreign exchange is required for the purchase of imports. A decline in its availability or in its purchasing power constrains import volume to lower levels. In relatively good times some countries may have some "slack" in their import bills that can quickly be reduced or eliminated. But recently these have been the exception. Output may consequently drop below already realized levels even though there has been no decline in the immediate availability of labour, capital or domestic resources. For instance, a shortage of oil may force industrial output or the transport system to operate well below capacity. Such a foreign exchange constraint may also impede investment and growth in future capacity if key capital goods, e.g. machinery and equipment, cannot be domestically acquired.

In highly flexible economies with a relatively diversified productive structure, when real foreign exchange earnings fall short of the economy's requirements, increased saving can reduce unnecessary imports and free output for diversion into exports the earnings from which can finance the needed imports. Thus the maintenance of investment and growth in the face of external shocks can, in many instances, quickly be achieved through an increased savings rate. Where, however, imports are already virtually all essential inputs to output or investment and export goods are not readily substitutable in domestic consumption or domestic consumption goods readily saleable on external markets, variations in savings cannot translate automatically into the desired effects upon import volume. In these latter cases - more typical of developing countries - a "foreign exchange constraint" on output and growth rather than a savings constraint exists.

In the medium to long-term, foreign-exchange constrained economies can restructure themselves by developing new import-substituting activities and new export industries. Even in the shorter run they may be able to alter the composition of overall demand somewhat so as to lower import requirements, e.g. by increasing labour-intensive and local material-using investment (e.g. construction) relative to others, and more generally substituting less import-intensive expenditures for more import-intensive ones. Typically, aggregate consumption expenditures are less import-intensive than aggregate



investment activities; cutbacks in investment programmes are therefore particularly effective in reducing the import bill. But a considerable degree of short to medium-term rigidity characterizes the economy of most developing countries; and there are limits to what can quickly be achieved through restructuring of supply or demand. Inability to finance required imports then translates into reduced output and particularly reduced investment. The resulting loss in current and future national income is additional to that which is the direct result of the external shock. It can result from the fact that the foreign-exchange constrained economy is forced to operate below its actual capacity to produce (as determined by its available factors of production - capital, skill, resources, labour, etc.). In many instances, the output of only some sectors is constrained in this way at the same time as the output of others is not. The distribution of the burden of these output (and income) cuts depends upon the precise means by which import volume is constrained - through reductions in public or private demand, direct import controls and allocations of foreign exchange, or by other means. Investment cutbacks obviously have implications for future growth, and, potentially, for future sectoral imbalance. Investment instability also disrupts planning processes and imposes further growth costs.

Required short-term national adjustments to external shocks for which there is inadequate offsetting increased financing available therefore can be seen in terms of (1) increased savings (reduced consumption) and reduced investment; and (2) increased exports out of the existing output and reduced imports. In the terminology of the empirical analysis which follows, (see the terms of reference in the annex below), these two categories of national response are described, respectively, as changes (contraction) in "domestic spending" and changes (improvements) in "trade ratios". In most developing countries, the latter - more fundamental - type of adjustment is likely to require increased, as well as restructured, investment.

Several empirical analyses of recent external shocks and policy responses to them in developing countries are now available. Their methodologies are broadly similar. All basically seek to decompose both shocks and policy responses into their principal constituent elements. (Balassa, 1980; World Bank, 1981; Balassa and McCarthy, 1983; Mitra, 1983 and 1984; Naya, Kim and James, 1984). The impact of external shocks is typically estimated by comparing actual events with what would have happened in the absence of the shocks. Thus the negative effect of the shocks upon the current account of the balance of payments, and their adverse impact reflected in a worsening of the terms of trade, reduced export demand (volume), and higher interest rates, can all be estimated by reference to a counterfactual world in which these blows are assumed not to have occurred. The estimated deterioration in the current account (relative to the assumed counterfactual world) is then usually expressed as a percentage of actual GNP or GDP.

This is, of course, a rather crude accounting procedure that gives little idea of the complexity of interrelationships within an economy. To begin to establish the full effects of particular external shocks one would need a complete model of the economy in which all the relevant interrelationships were taken more fully into account. Among the effects of any such shocks would, of course, be changes in GNP (or GDP) itself. Some recent empirical investigations have attempted to proceed in this manner (Mitra, 1983 and



1984), and they have generated interesting preliminary results. For the purposes of our investigation, Edmar Bacha developed a relatively simple demand-driven macro-economic model, about which more below (1983).

Calculations of this type may be made for short periods or for longer ones. Table 4, for instance, shows the ratio of external shocks (defined in this case as terms-of-trade deterioration relative to 1971-1973 plus decline in export volume growth below the previous growth trend) to GNP for 12 Asian countries over the entire 1974-1982 period. It can be seen that Indonesia and Malaysia, oil exporting countries, enjoyed favourable shocks over the period, whereas Singapore, Hong Kong, Pakistan, Sri Lanka and the province of Taiwan experienced severely adverse ones. Analyses carried out within the World Bank also have covered the 1963-1978 period for 13 oil-importing semi-industrialized countries (including Brazil, Mexico, Republic of Korea and the Philippines, in our sample) (Mitra, 1983) and the 1974-1981 experience of 34 developing countries (Mitra, 1984).

More frequently calculations of these shocks have been undertaken with reference to shorter periods. The impact of external shock is, after all, registered virtually immediately upon a national economy. Policy response, both at the national and at the international level, must take place in the short run. Among the crucial analytical questions are those concerning the length of time that appropriate adjustment requires, the adequacy of external finance permitting it to be made, and the medium-term to long-term implications of inadequate or inappropriate short-term adjustment. These issues are being debated vigorously in the industrialized world as well as in the developing countries (Calmfors, 1983). It seems sensible, therefore, to conduct empirical investigations relating to shorter periods, such as those of the traditional business cycle and specifically, in the present context, the two recent periods of global recession following major oil price increases - 1973-1975 and 1979-1982/83. Of particular concern in this study has been the impact of severe shocks of the 1979-1982/83 period - principally a complex of export volume effects, terms of trade effects, and interest rate effects. Table 5 shows figures calculated in one recent attempt to estimate the absolute impact of the major components of external shock in the aggregate of all non-oil developing countries over the 1979-1982 period. It demonstrates the changing relative incidence of the "oil effect", terms of trade deterioration and export volume decline under the heading of a "world recession effect", and interest rate effects; the influence of oil is seen to be falling and that of recession and interest rates rising over time.

Measurement of governmental response, on the face of it, should be more difficult and problematic. The appropriate governmental response to an external shock is much easier to assess with the wisdom of hindsight than it is at the time when policies must be constructed. Information upon which policy is based is always imperfect. Expectations as to the temporariness of the shock and the availability of external finance are both particularly crucial and particularly difficult to get right. Neither rich countries nor poor are spared the difficulties of forecasting the future in circumstances of extreme uncertainty. Needless to say, governments also vary in their responsiveness to various domestic interests; their capacity to analyse and implement various alternative economic policies; their rates of time preference (or preference for current consumption versus investment in the

Table 4

Size of external shocks and the ratio of external shocks  
to gross national product

(Average of 1974-1982)

Country	External Shocks (\$ million)	Ratio of External Shocks to GNP (%)
<u>Newly Industrializing</u>	-2,833.7	-24.8
Province of Taiwan	-2,360.4	-12.7
Hong Kong	-2,800.1	-26.7
Korea, Rep. of	-3,668.2	-13.3
Singapore	-2,506.1	-46.3
<u>South-East Asia<sup>a/</sup></u>	-2,462.9	-14.9
Indonesia	7,740.9	23.6
Malaysia	696.9	6.4
Philippines	-2,531.8	-14.5
Thailand	-2,394.0	-15.2
<u>South Asia</u>	-1,885.2	-14.2
Burma -50.8	-1.8	
India -3,808.7	-4.6	
Pakistan	-3,152.9	-26.8
Sri Lanka	-528.5	-23.5

Source: Naya, Kim and James, 1984, p. 4.

a/ Average for the Philippines and Thailand only.

Note: "Shock" = worsening of terms of trade and decline in growth of export volume below trend (see text).

Table 5  
Sources of deterioration in the current account of  
non-oil developing countries, 1979-82  
(billion of dollars)

	1978	1979	1980	1981	1982	Cumulative 1979-82
Actual trade balance	-36.6	-51.3	-74.3	-79.6	-52.2	-
Adjusted trade balance <sup>a/</sup>						
Oil effect <sup>b/</sup>	-46.3	-46.3	-57.3	-47.8	8.8	-
	5.0	5.0	17.0	18.6	14.8	55.4
World recession effect <sup>c/</sup>	-	-	-	13.2	46.2	59.4
Export volume <sup>d/</sup>	-	-	-	-	23.2	23.2
Terms of trade <sup>e/</sup>	-	-	-	13.2	21.3	34.5
Interest payments on debt Service (gross)	-19.4	-28.0	-40.4	-55.1	-59.2	-
Interest rate effect (gross) <sup>f/</sup>						
Interest rate effect (net) <sup>f/</sup>	-1.1	-1.1	.5	11.4	23.0	33.8
	-5	-5	.2	6.5	14.0	20.2
Actual current account	-41.3	-61.0	-89.0	-107.7	-86.6	-
Adjusted current account <sup>g/</sup>	-41.3	-56.5	-71.8	-69.4	-11.8	-

Source: Fishlow, 1984, p.36.

Notes:

- a/ Adjusted trade balance: Actual trade balance minus sum of oil and recession effects.  
b/ Oil effect: Actual cost of net imports of oil (using oil import price of industrialized countries) minus estimated cost using oil price that varies after 1978 with export prices of oil-importing countries.  
c/ World recession effect: Composite terms of trade and volume effects (does not add because of interaction).  
d/ Export volume: Non-oil export value times cumulative negative percentage deviation between actual export volume of oil-importing countries and volume predicted by 3.2 per cent industrialized-country growth in 1980-1982.  
e/ Terms of Trade: Cumulative negative percentage deviation between actual non-oil terms of trade (export price of oil-importing countries) and predicted oil-importing price of oil-importing countries in 1973/74, 1979-1980 non-oil countries in other years. Terms of trade predicted by 3.2 per cent OECD growth and deceleration of industrialized-country inflation at 1 percentage point per year beginning in 1979.  
f/ Interest rate effect: Based on difference between the 1975-1978 average real interest rate and actual real rates. For short-term interest payments, the US prime rate was used. Interest on long-term and medium-term loans was calculated by using the real US prime rate with a weight of 1/3 and the OECD long-term fixed interest rate with a weight of 2/3, corresponding to portfolio weights reported in OECD, External Debt of Developing Countries, Paris, 1982. Rates were applied to average annual debt, obtained by using average of year-end debts. Net interest effect includes the offsetting earnings from short-term assets. This method approximates well the actual gross and net interest payments reported in IMF, World Economic Outlook (Washington, D.C., 1983).  
g/ Adjusted Current Account: Actual current account minus sum of oil effect, recession effect, and net interest effect.

interest of future generations); their degree of risk aversion; and their ideological preference with respect to the degree of external dependence, the role of the market, etc. It would therefore be foolhardy to attempt to "judge" governmental performance on the basis of some universal scale. What can be done, however, is objectively to measure changes in certain economic characteristics, analyse the role that governmental policies may have played in generating or offsetting such changes, and to assess their implications for the (still uncertain) future. This emphasis upon changes implies the use of a "norm" or "counterfactual", just as in the "shock accounting" described above, in which the economic characteristics in question remain the same. This procedure, adopted in this study as in others, does not imply that the unchanged counterfactual world is necessarily a desirable or even a sustainable one. And it remains a far cry from complete modelling of policy responses and adjustment processes.

Policy response to shocks to the current account may take a variety of forms. Durable structural adjustment, restoring external balance to normal levels and rates of growth of economic activity, involves export promotion or import-substitution which together may be described, in Bacha's terminology, as improved "trade ratios". Success may be measured, respectively, by increased shares of world markets and by reduced import coefficients in domestic spending. (To the degree that export "success" is achieved through domestic deflation or that it engenders overseas protectionist response it may not be altogether so durable. There may also be medium- and longer-term problems associated with short-term reductions in import coefficients. These measures are nonetheless likely to be good indicators of the progress toward required structural adjustment.)

Alternatively, it may be necessary to restore external balance by reductions in aggregate demand - reducing rates of investment and/or consumption (whether private or public) and thus both current and future GNP. In that such "belt-tightening" lowers capacity utilization and growth, it is presumably only resorted to as a short to medium-term measure, pending more fundamental readjustments. As has been seen, a third option - for some - is resort to external finance, which is obviously not available in unlimited quantities or without a price. Like the measurement of external shocks, measurement (decomposition) of policy responses may be undertaken for long periods or short.

### 3. SUMMARY ANALYSIS OF EXTERNAL SHOCKS AND POLICY RESPONSES IN DEVELOPING COUNTRIES IN THE 1979-1982 PERIOD

In our investigation of the impact and implications of external shocks particular attention was directed at the implications for growth of the resulting scarcity of foreign exchange. There is a long tradition in the development economics literature of special concern, in the context of developing countries that are relatively rigid in their demand and production structure in the short to medium term, with the need to import certain essentials without which some economic activities cannot take place. As has been seen, where imports cannot be obtained because external savings are insufficient to finance them and (saved) domestic output cannot be translated into foreign exchange, current output may fall below the potential implicit in



the existing stock of factors of production and other inputs. Moreover, owing to constrained investment activity, future growth may also fall. These traditional considerations have resurfaced during the recent years of near-universal blows to foreign exchange availability.

Bacha's methodology for decomposing the effects of changes in the current account deficit explicitly allows for the possibility of underutilization of capacity because of foreign exchange scarcity. In those countries in which the data permit the full calibration of his model to domestic circumstances all of the "effects" of external events or domestic policies are therefore expressed in terms of potential output (GDP rather than GNP because of data limitations) instead of, as in the other methodology, actual output. (Where, as in the Indian case, it is assumed that the economy has been operating at the rate of its potential output, except to the extent that it falls short of the potential because of weather influences upon the harvest, there is obviously no difference.) When one applies Bacha's projection model the possibility of a foreign exchange constraint assumes major importance. Indeed, as will be seen below, it is the availability of foreign exchange, as determined by export demand and net foreign financial inflows, that "drives" his projection results. But neither in the analysis of the impact of recent shocks nor in that of policy responses that follows is the possibility of drawing a distinction between a savings constraint and a foreign exchange constraint at all crucial to the analysis.

In the methodology employed in this study (for details of the methodology see the annex to this paper), external shocks are categorized as terms of trade deterioration, interest rate shocks, and retardation of world trade growth. All are measured as percentages of actual or potential GDP and in US dollars. A further determinant of the current account position is the burden of accumulated debt, the impact on the current account of the increase in external borrowing since the last accounting period; this too is expressed as a percentage of GDP. (In Appendix tables 1-3 at the end of this paper, where some of these results are presented, this is the main component of "other external variables".) Domestic policy responses are divided into changes in "domestic spending" and changes in "trade ratios". The former are made up of the consequences of reductions in gross investment and in aggregate consumption. Changes in trade ratios are made up of those in the "export ratio" (national export shares in world markets) and those in the "import ratio" (import coefficient of domestic spending). Each of these measures of domestic policy response is expressed as a percentage of actual or potential GNP or GDP. Allowing for interaction terms and errors, the sum of the measures of external shock, other external variables and domestic policy response should add up to the actual change in the ratio of the current account deficit to GDP.

It has not been possible as yet to piece together all the necessary data to permit a full Bacha-style analysis of the impact of the 1979-1983 external shocks on developing countries and the range of their policy responses. It has not even been possible to achieve this objective for the small sample of countries on which these studies were initially meant to concentrate. Table 6 presents illustrative summary data, however, on the main elements of such analysis of three important developing countries within our sample, each with its own specific adjustment experiences: Brazil, Republic of Korea and the

Table 6

Sources of current account change between 1978 and 1983

As percentage of potential GDP

	External Shock <sup>a/</sup>	DOMESTIC SPENDING <sup>b/</sup>			TRADE RATIOS <sup>c/</sup>			Other <sup>f/</sup>	Observed Deficit Increase
		Gross Investment	Consumption	Total	Export Ratio <sup>d/</sup>	Import Ratio <sup>e/</sup>	Total		
Brazil	5.60	-0.40	-0.99	-1.39	-2.25	-2.65	-4.90	1.02	-1.20
Korea, Republic of	4.96	-0.98	-3.79	-4.77	0.12	-0.84	-0.72	1.14	0.61
Philippines (1982)	2.65	N.A.	N.A.	-0.44	1.01	0.48	1.49	-0.39	3.31

a/ A positive sign denotes an adverse external shock, such as a terms of trade deterioration, an interest rate increase, or a deceleration of world trade. A negative sign denotes a favourable external shock.

b/ A positive sign denotes an expansion of domestic spending, which increases the deficit. A negative sign denotes a contraction of domestic spending, which reduces the deficit.

c/ A positive sign denotes a movement of the trade ratios which increases the deficit. A negative sign denotes that the trade ratios moved to reduce the deficit.

d/ A positive sign denotes a reduction of the exports to world trade ratio. A negative sign denotes an increase of the export ratio.

e/ A positive sign denotes an increase of the import content of domestic spending. A negative sign denotes a reduction of the import ratio.

f/ The difference between the observed deficit increase and other recorded items. A positive sign denotes an unfavourable movement of other external variables, such as a net accumulation of foreign indebtedness between the beginning and the end of the period. A negative sign denotes a favourable movement of other external variables.

Philippines. Each has incurred significant external debts, and each ranks among the top five debtor developing countries not members of OPEC (along with Argentina and Mexico). Brazil and the Republic of Korea are generally categorized as semi-industrialized economies and the Philippines, with a per capita income of \$820 (1982 dollars), is the largest non-oil-exporting country among those the World Bank classifies as "lower middle-income" developing countries. Access to credit and considerable supply adaptability have probably made the adjustment experiences of these three countries somewhat "easier" than they have been in the majority of developing countries, and certainly than in the poorer and less diversified ones. These data are not intended to be, in any sense, representative of a "typical" situation in developing countries but rather to illustrate a range of actual experiences.

Between 1979 and 1983 external shocks were severe enough to raise the ratio of the current account deficit to capacity output (potential GDP) by several percentage points in all three countries. In Brazil this shock amounted to 5.6 per cent of potential GDP, most of it attributable to terms of trade deterioration. In the Republic of Korea the initial shock, also primarily the product of terms of trade deterioration, was considerably greater than the 4.96 per cent shown for 1983; by 1983, some of the effects of the initial blow had already been reversed. Brazil and the Republic of Korea both restructured their activities in appropriate directions in response to these shocks. Brazil achieved both penetration of export markets and a further reduction of import coefficients in domestic spending - beyond the significant reductions previously realized from 1975 to 1978. The Republic of Korea's export success, which had been dramatic earlier in the 1970s, was limited during this period; but it achieved some success in reducing import coefficients. In neither case, however, were these adjustments sufficient fully to compensate for the effects of the external shocks plus the growing impact upon payments obligations of the rising external debt. Both therefore were forced to cut output and investment; in the Republic of Korea's case the effect of the contraction in output upon imports was very nearly as large as that of the external shock itself, whereas in the Brazilian case relatively much less of the adjustment burden was borne by domestic recession. The fact that Brazil adjusted primarily through restructuring its trade whereas the Republic of Korea did so primarily through domestic recession has not been widely recognized. In the Philippines, where the calculated external shock was smaller than in the other two countries, there was actually a deterioration in export performance and increasing import-intensity in domestic demand; at the same time aggregate output did not contract significantly either. Major macro-economic contraction took place in 1984, and overdue structural adjustments will be necessary in the years to come. Further details of these (and other) countries' experiences can be found in the individual case studies (for a summary see Section 5 below).

Bacha's methodology was employed, wherever possible, in the detailed country studies in this project, but some data, and particularly data relating to potential output, were difficult to obtain. It was therefore decided to conduct a slightly modified version of the analysis for as many countries as possible on the basis of data available from international sources. It differs from the preferred methodology in that actual GNP rather than potential GDP is employed as the "norm" for all measurements. Some of the details of this country-level analysis, illustrating the great variety of developing country experience, will be found in Appendix tables 1-3 at the end of this paper.

Table 7 summarizes the results of this analysis of external shocks and domestic policy responses in 25 developing countries (21 in the 1978-81/82 period) during the 1970s and early 1980s. This list of countries contains all of those in our sample of seven except Zimbabwe. The data indicate the changes between the first year and the last year shown, not averages over the period with reference to a prior base period as in table 4 (above) or other analyses discussed in the Appendix.

External shocks have been very severe indeed, with the impact on the current account deficit averaging between 8.5 and 10 per cent of GNP (medians of between 4.6 and 7.5 per cent), in the countries that were negatively affected by them. The shocks of the post-1978 years arrived at a time when the negative impact of the 1973-75 shock had been only slightly eased. "Shock accounting" for the entire 1973-81/82 period would obviously show considerably larger numbers than those that break it into two separate periods, as this analysis does.

Of those in our sample, the number of countries suffering adverse external shocks in the 1978-1981/82 period was slightly smaller than the number experiencing them earlier in the 1970s, and the median adverse shock as a percentage of GNP also fell (although the mean rose). In this analysis, Sri Lanka is recorded as having experienced the largest adverse shock in the 1979-82 period; in the earlier (1973-75) period of shock, however, this dubious distinction rests with Zambia.

An important finding, on which other studies have not reported, is that there was a significant change in the nature of policy responses among those countries that experience adverse external shocks in the later period. In the 1973-75 period slightly over half of the countries experiencing current account shocks responded by means of improved export ratios (11 of 21) or import ratios (12 of 21); the average impact of these "successes" was relatively modest, however, when expressed as a percentage of GNP (0.6 and 0.3 per cent respectively). By 1978 the impact of the earlier shocks had eased a little, reducing the total number of adversely affected countries and the average negative impact upon them. Previous import replacement was reversed among the majority of those still having experienced an adverse external impact since 1973; i.e., the import-intensity of domestic spending increased in 10 of 18 countries, with, on average, consequential adverse effects on the current account. Improved export competitiveness was, however, retained.

The 1973-75 external shocks also produced effects on aggregate spending in the adversely affected countries. In 13 of these 21 countries current account improvements were realized by reductions in aggregate consumption; on average, the resulting impact upon the current account was smaller than either the export competitiveness or the import replacement effects but it was favourable. Contraction in investment was not frequently undertaken during this period. Only six out of 21 adversely affected countries achieved current account improvements in this way, and four of them were of minuscule dimensions (0.1 per cent of GNP or less). On average, continued investment expansion contributed to a further deterioration in the current account in these countries. Between 1975 and 1978 these countries, on average, tightened consumption a little, whereas investment expenditures continued roughly as



Table 7

The impact of external shocks and domestic policy responses upon current account deficits as a percentage of current GNP, 1973-75, 1973-78, and 1978-81/82

	COUNTRIES EXPERIENCING EXTERNAL SHOCKS		DOMESTIC POLICY RESPONSES IN COUNTRIES EXPERIENCING ADVERSE SHOCKS*							
	Favourable No.	Adverse No. Ave. % (median)	Improved Export Ratio	No. Ave. % (median)	Improved Import Ratio	No. Ave. % (median)	Gross Investment Contraction	No. Ave. % (median)	Consumption Contraction	No. Ave. % (median)
1973-75	4 <sub>a</sub> /	21 8.5 (7.5)	11 -0.7 (-0.6)	12 -0.8 (-0.3)	6 0.5 (0.2)	13 -0.6 (-0.2)				
1973-78	7 <sub>b</sub> /	18 7.3 (4.95)	11 -1.2 (-0.6)	8 -1.2 (+0.2)	5 0.1 (0.4)	13 -1.9 (-0.4)				
1978-81/82 <sub>d</sub> /	7 <sub>c</sub> / <sub>d</sub> /	14 <sub>d</sub> / 9.95 (4.65)	12 -3.0 (-2.9)	8 -4.5 (-0.65)	9 -0.5 (-0.35)	4 +0.0 (+1.5)				

Source: Appendix tables 1-3.

\* Negative sign indicates deficit-decreasing policy change. Positive sign indicates deficit-increasing policy change.

a/ Dominican Republic, Indonesia, Morocco, Venezuela.

b/ Colombia, Costa Rica, Indonesia, Ivory Coast, Sri Lanka, Tanzania, Venezuela.

c/ Argentina, Egypt, Indonesia, Mexico, Peru, Sudan, Venezuela.

d/ Inadequate data required the omission of Ivory Coast, Morocco and Zaire. Of those recorded, data for the following 8 countries cover only the period through 1981: Costa Rica, Egypt, India, Indonesia, Sudan, Tanzania, Turkey, Uruguay.

before (with one less country recorded as having reduced its current account by investment contraction since 1973).

In the 1978-81/82 period, of the 14 countries experiencing adverse external shocks, nearly all (12) offset them to some degree by increasing export competitiveness; and the impact upon their current accounts, expressed as a percentage of GNP, was a multiple of that achieved by such improved export deepening in the previous period. The median improvement in the current account achieved via export ratios (i.e., increased export competitiveness), was nearly five times as large in the post-1978 period as it was in the previous "shock" years; this may, in part, reflect lags in the response capacities of productive processes to new policies and incentives. Further improvements in the current account were realized by reduced import ratios during this period. While the number of countries achieving success in this respect was smaller in the post-1978 period than it had been in the 1973-75 period, it was still more than half of the adversely affected countries; and the average improvement was much greater in the later than it had been in the earlier period. Again, the significantly larger average improvements in the current account recorded as resulting from reduced import ratios during the second period of shock may be the product, in part, of delayed responses to import replacement policies of earlier years.

As far as measured aggregate spending effects are concerned, the experience of the 1978-81/82 period has been quite different from that of the 1973-78 period. Whereas in the earlier period a majority of adversely affected countries improved their current accounts by cutting consumption expenditures and only a small number of countries reduced investment, the pattern this time was reversed. Only four of 14 affected countries offset the shocks by contracting consumption (as against 13 of 18 in 1973-78 and of 21 in 1973-75); on average, consumption expansion tended to increase the current account deficit. On the other hand, nine out of 14 affected countries this time responded by investment expenditure contraction. On average, affected countries reduced their current account deficit in the 1978-81/82 period by means of investment cuts by roughly the same share of GNP as they had done by consumption cuts in the 1973-75 period. In both periods, the impact of expenditure cuts, as measured in this analysis, was dwarfed by adjustments in export and import competing performance. Of the nine countries resorting to investment contraction in the later period, five had resorted to consumption contraction but not investment contraction during the 1973-75 period, which suggests that while it may be possible to cut some "slack" from consumption, a limit is reached beyond which it may be easier to borrow from the future by reducing investment instead. (One other country that cut back investment in the 1978-82 period - Zambia - had previously reduced both investment and consumption, and now, while cutting investment, expanded consumption again.)

In the interpretation of these tables it is important to recognize the stringent underlying requirements for decreasing the proportion that the current-account deficit makes up of GNP. Assuming an import coefficient for fixed investment of 0.33 the achievement of 1 per cent (of GNP) improvement in the current account via investment contraction implies a 3 per cent reduction in gross investment's prior share of GNP; in larger and more closed economies like those of Brazil and India, where the import coefficient of domestic expenditure is more like 0.10, the same improvement via investment cuts

implies a 10 per cent reduction in the ratio of gross investment to GNP. Since the import coefficient of consumption expenditure is typically lower than that for investment the achievement of similar current account improvements via reductions in consumption would imply even larger contractions in the ratio of consumption to GNP (increases in the savings rate). (In the 25-country analysis reported here data limitations did not permit differentiation between investment and consumption import coefficients; this differentiation was specifically incorporated, however, in some of the more detailed country case studies.) In the simpler analyses that do not express investment (or consumption) as a percentage of some fixed output value (in Bacha's methodology "potential output"), the required absolute reductions in domestic spending will be somewhat understated by even these large numbers since output is itself likely to be falling.

This analysis relates only to a limited sample of developing countries for which data are readily available. It employs a highly aggregative methodology. It nevertheless makes it possible to draw the following conclusions:

- (i) A large number of developing countries have suffered two successive periods of very severe externally-originating shocks to the balance of payments;
- (ii) On average, while there are important exceptions, these countries have achieved considerable structural adjustment by increasing export ratios (competitiveness) and, to a lesser extent, decreasing import ratios (import replacement); and their accomplishments in these respects have grown with time;
- (iii) While, during the first period of external shock, most of these countries were able to maintain investment programmes, the majority have been forced, during the second such period, to curtail them, with obvious negative implications for future growth and welfare.

#### APPENDIX TO SECTION 3

Balassa and McCarthy (1984) have employed the methodologies discussed above to analyse (for the World Bank) external shocks and policy responses in 30 developing countries in the 1979-81 period. Twenty of the countries in our 25-country analysis are included in their sample. Their sample also includes 5 of the countries selected for detailed analysis in our study: Brazil, India, Ivory Coast, Republic of Korea, Philippines. Their results are summarized in table 8.

Of their 30 countries, 23 suffered aggregate (overall) unfavourable shocks in the 1979-81 period (against 21 of 29 in the 1974-78 period). Several oil-exporting countries, including Mexico, are among the latter group as export volume declines and interest rate increases more than offset improvements in their terms of trade. As in our analysis, the largest average shock is recorded as that of Sri Lanka, which suffered a deterioration in its





current account amounting to 20.2 per cent of its GNP; this was actually a smaller blow than Sri Lanka is recorded as having suffered in the 1974-78 period when it was also the most severely affected. (In our analysis, Zambia, which is not in the Balassa-McCarthy sample, suffered the greatest adverse shock in the earlier period.)

In table 8, the magnitudes of the various sources of external shock are recorded as percentages of the total shock. For most non-oil countries, aggregate external shock effects were dominated by changes in the terms of trade, although the Republic of Korea and Pakistan suffered more from export volume decline, and Chile and Argentina from interest rate increases. The average data shown in this table conceal the fact that all three measures of external shock increased within the three-year period (and they undoubtedly increased further in 1982 for which data were not yet available). By 1981, the authors record, the average adverse balance-of-payments effects of external shocks in the post-1979 period exceeded those of the 1974-78 period in a large majority of cases.

Policy responses were divided by these authors into export promotion, import substitution, macro-economic policies and net additional external financing. Export promotion was estimated by comparing the period's export market shares with 1976-78 norms; import substitution and macro-economic policies were estimated by comparing income-elasticity of demand for imports and growth rates, respectively, with those of the 1963-73 period. Additional external financing was estimated on the basis of trends from the 1963-73 period applied to data for the later period. These estimates were then expressed as percentages of the aggregate external shock so that the four responses recorded in the table add up to 100 in each country. The authors also expressed the measures of export promotion, import substitution and macro-economic policy effects as percentages of exports, imports and GNP, respectively, to indicate the magnitude of the policy efforts; the results are described as "policy response ratios". They then go on to assess policy performance in terms of an arbitrary scoring system.

Policy responses, like external shocks, prove to vary greatly from one country to another. In the summary way in which the data are reported they are not easy to interpret. It seems, however, that of the 23 countries suffering adverse external shocks, according to the summary table, 16 responded with improved export performance, 14 with import substitution in fuel and 12 in non-fuel, and 15 reduced imports by macro-economic contraction. Overall, the authors find no apparent correlation between the size of external shocks and measures of "policy effort", nor much correlation between "policy effort" and actual short-term economic performance. The latter result underlines the importance of lags and the need for sufficient time to permit policy efforts to bear fruit. The former suggests the need for more detailed analysis of specific countries' history and circumstances, not least their experience in the previous period of severe external shock.

Mitra's analysis (1984) of the 1974-81 period included 6 of our sample countries (except Zimbabwe). He classified the 34 countries he studied according to the manner of average adjustment over the period. Of our sample countries, he lists the Philippines and the Republic of Korea as having

adjusted via "export expansion and public resource mobilization"; and Brazil and India as having done so via export expansion without public resource mobilization. Mexico was able to respond, according to this analysis, by "financing without adjustment"; and the Ivory Coast is recorded as having benefited from external shocks. Apart from the fact that the data are not as current as one might like, he does not report impacts and responses to the 1973-75 and the 1979-81 shocks separately.

#### 4. ANALYSIS OF THE MEDIUM-TERM GROWTH PROSPECTS OF DEVELOPING COUNTRIES

Macro-economic forecasting is a precarious business. Forecasting for countries that are heavily dependent upon external events requires that these events themselves be forecast as well as independent domestic performance. In a project like this it is obviously not possible to generate new global projections of growth rates, inflation, interest rates or commodity prices in the OECD. The most that can be done is to achieve consistency as to global forecasts as each national-level projection is undertaken. This consistency may itself be spurious because of the fallacy of composition: if all the national units proceed on the assumption that each is unable to affect global events and on the basis of the same projections of prospects, they may collectively falsify the global forecast. For example, if all pursue policies of export expansion with a view to securing increased market shares the most likely outcome is increased protectionism and collectively lower export growth prospects.

In these studies, projections have been made only for the seven countries which were the subject of more detailed macro-economic analyses. A common methodology, to which reference has already been made, was employed. Common assumptions as to broad global prospects were employed in each country analysis, although sensitivity tests of alternative possibilities relevant to the specific circumstances of the country were also undertaken. The key "base case" assumptions for the 1984-1989 period for which the projections were: 3 per cent annual average real GDP growth in the OECD, 5 per cent annual average rate of dollar price inflation, 5 per cent average real interest rate (LIBOR) and no average change in international terms of trade (relative prices).

The basic scenario of the IMF's World Economic Outlook, 1984, was a little more optimistic, assuming an OECD growth rate averaging 3.25 per cent for the 1984-90 period, a decline in nominal interest rates to 7 per cent by 1988, and a world inflation rate of only 4 per cent. Each of these assumptions looks optimistic in the light of more recent information and other projections (Dornbusch and Fischer, 1984). Bank lending is projected by the IMF to grow at 7 per cent per year, a lower rate than the projected growth rate of exports, with the inevitable outcome in their forecasts of an improving debt-export ratio.

As has already been noted, Bacha's projection model devotes particular attention to the possibility of a foreign exchange constraint. It treats as exogenous the principal sources of foreign exchange - external demand for exports, the terms of trade and foreign capital inflows - and some elements in

the determination of its uses - the interest rate paid on external liabilities and domestic foreign exchange reserve accumulation. The exogenously determined current account deficit also implies accumulation of external liabilities and, depending upon the degree of concessionality and commercial interest rate levels, a particular future pattern of debt servicing obligations. Thus the "free" foreign exchange available for use in the purchase of imports, both in current and future periods, is given by external events. Assumptions as to import coefficients in alternative uses - basically investment goods or inputs to overall output - and savings behaviour complete the elements of the model. It is assumed that import coefficients and export volume cannot be rapidly altered, although the possibility of some changes can be allowed in particular simulations. In these circumstances the level of GDP may be constrained either by the level of past investment allowing for depreciation (i.e. full capacity output cannot be exceeded) or by inability to finance the imports upon which the full attainment of the purely demand-determined level of output depends. In the latter case, if the level of investment demand were raised, GDP could also rise but for the fact that this increased demand would also raise imports that cannot be financed. In such a case the return from the increased provision of foreign exchange may be very high, whereas that from increased domestic saving is low and, in the short run (as demonstrated in the Brazilian and Zimbabwe cases) even negative. (Bacha, 1984).

Medium-term projections (through 1989) of the prospects for our sample of developing countries have been based upon assumptions as to national export growth, terms of trade and interest rates that are consistent with informed current opinion held both internationally and among policymakers of the countries themselves. Careful macro-economic analysis of the recent past was combined with detailed local knowledge to generate reasonable forecasts of crucial domestic parameters - savings rates, investment rates, import coefficients, incremental capital-output ratios, spreads over LIBOR, the inflow of foreign capital, etc. Some of the key parameters in the national forecasting models are shown in table 9. Where the values of these parameters can be expected to change in response to domestic policy or for other reasons, the possible change has been taken into account. The sensitivity of the results to changes in key assumptions has also been tested, notably sensitivity to changes in real export growth, the terms of trade, import coefficients, external interest rates, domestic savings rates and levels of external finance. Particular attention is devoted to prospects for exports and external finance.

Export success depends upon the growth rate in the principal countries to which export commodities are to be sold, trade barriers in these same countries, and the extent of domestic incentives for exporting. Dornbusch and Fischer argue persuasively that previous analysis (notably that of Cline, 1983) substantially overestimated the impact of OECD growth on developing countries' exports. There is also now disquieting evidence that recovery in OECD growth has not this time been accompanied by an easing of protectionist restrictions against developing countries (IMF, 1984b). On the other hand the influence of changes in interest rates upon the degree of developing countries' payments pressures, particularly in the case of large debtors like Brazil and Mexico, appears to have been underestimated. Interest rates depend upon the degree of restraint and the monetary-fiscal policy mix in the OECD countries, principally in the United States. The favourable impact of faster

Table 9

## Assumptions employed in the country-level projections, 1984-1989

## A. Basic assumptions concerning the world economy

Real GDP growth in industrialized countries - 3%  
 Rate of inflation (dollar prices) - 5%  
 Terms of trade - no change  
 Real LIBOR - 5%

## B. Basic assumptions concerning individual economies

	Real Export Growth Rate (%)	Nominal Interest Rate* (%)	Marginal Import Coefficients	Capital Goods	Others	Marginal Savings Coefficient	Incremental Output-Capital Ratio
Brazil	5 to 7	10.5	.09		.075	.155	.413
India	5	2-4	.095		.065	.220	.380
Ivory Coast	5	17.6	.26		.137	.254	.49
Korea, Republic of	8 to 8.35	10	.30		.24-.30	.24	.38
Mexico	4.5	13	.16		.16	.20	.40
Philippines	6	8.8	.14		.17	.178	.33
Zimbabwe	6	9	.55		.25	.15	.36

\*Including rate of return on direct foreign investment. The intercountry variation in the "basic" assumptions concerning nominal interest rates reflects divergence in recent experience - itself the product of differences in the degree of concessionality in external borrowing, the relative role of direct foreign investment, spreads over LIBOR, and other factors.



OECD growth, which is good for developing countries' export prospects, may be somewhat offset by consequential increases in international interest rates.

It seems, then, that the combined implications for developing countries of slower-than-expected OECD growth, greater-than-expected protectionism in the countries members of OECD and higher-than-expected interest rates may be very much more serious. This somewhat more sober scenario implies that a higher flow of medium-term external adjustment finance is required if the favourable results of earlier projections, including those relating to the medium-term resolution of debt problems, are to be realized.

## 5. EXPERIENCE OF INDIVIDUAL COUNTRIES: A SUMMARY

### (a) Brazil (Bacha, 1984)

The oil and recessionary shock of 1973-1975 hit Brazil in the midst of a period of unprecedented expansion, first with severe terms of trade deterioration and then additionally with retardation of world trade growth. The growth of the Brazilian economy nevertheless continued and such adjustments as were recorded took place primarily through the replacement of non-oil imports, notably capital goods, and the expansion of non-coffee exports. The share of Brazilian coffee in world markets declined sharply, however, during the 1974-1978 period. Failure sufficiently to substitute domestic products for oil imports or to penetrate world markets while growth proceeded implied a substantial expansion of external debt, mainly from commercial sources.

From 1978 onwards, Brazil was hit by even heavier external shocks, which became progressively more severe. Deterioration in the terms of trade remained the prime source of these external blows, but high and rising interest rates and the steady slowdown in the growth of world trade also added significantly to Brazil's difficulties. By 1982-1983 these combined shocks to the current account amounted to 5.6 per cent of potential GDP. While the Brazilian policy response was a little late - macro-economic expansion continued in 1980 - the adjustment eventually achieved both with increased import replacement and in world market penetration for its exports was very substantial. Delay in these adjustments in "tradeability" or inability to achieve them more rapidly required macro-economic contraction from 1981 onwards. Nervousness in international financial markets, caused by the Mexican debt crisis and other external factors, generated even greater difficulties for Brazil from late 1982 onwards, as previous levels of external finance were reduced and the rollover of previous debt was no longer assured. Domestic contraction now had to be severe while at the same time an international "rescue" package involving official credits, further commercial bank finance and an IMF programme was rapidly put together.

In Brazil, if external financing is sharply curtailed in the next decade, and surpluses on current account are indeed to be realized by 1987, as current programmes assume, the implications for output and investment must be bleak. Under the currently proposed austerity programmes, Brazilian per capita GDP

will still be 20 per cent lower in 1989 than it was in 1980; and growth will continue to be slow. Domestic austerity alone - cutbacks in investment and output - will do little for eventual Brazilian recovery if foreign exchange availability is not increased. Import coefficients cannot be driven much lower, and hence the principal way out of these constraints is through export expansion, a policy that must be vigorously pushed but one that faces obvious difficulties in the prospective world environment.

Assuming vigorous export growth (at a real annual rate of 7 per cent) and more or less unchanged global conditions, it would be possible for Brazil to expand GDP at 6.5 per cent per year and regain 1980 levels of per capita GDP by the end of the decade, if the current account deficit remains constant in real dollar terms at the projected 1984 level; without the level of financing required by the present current account deficit the growth rate could be less than half as great. Eventually, the maintenance of such a high rate of growth in GDP requires a higher savings rate than the present one. But a policy calling for austerity and higher savings at a time when output is constrained not by capacity but by the availability of foreign exchange would seem to imply forgoing productive opportunities and growth potential.

(b) India (Ahluwalia, 1984)

India suffered just as severe external shocks as those encountered by other non-oil developing countries. While their impact upon the current account expressed as a percentage of GDP was much smaller (1.4 and 2.2 per cent in the two periods, respectively) because of the relatively "closed" overall structure of the national economy, the need for adjustment to them was no less pressing in India than elsewhere. Adjustment to the first shock was relatively swift and painless, but that to the second and larger blow is not as yet complete. In the first period, there was relatively easy access to external finance, a significant increase in private transfers (from Indians newly employed in the Gulf), and a rapid improvement in the trade balance. Exports had been expanding rapidly even before the first shock, and Indian competitiveness now continued to improve. At the same time import coefficients for non-oil spending were reduced. These results were attributable to a policy of macro-economic restraint, including fiscal restraint which altered the overall composition of investment in favour of less import-intensive forms, and real effective depreciation of the rupee. In the second half of the 1970s vigorous growth resumed as weather was favourable to agricultural production and the external environment improved.

After the second oil shock, adjustment was not as easily achieved in India. Flows of long-term concessional external finance did not grow as they had done previously, with the consequence that debt servicing costs rose; nor, after an initial burst, was there this time much growth in private transfers from abroad. Although Indian export competitiveness continued to improve, the slowdown in world trade this time more than offset such gains, significantly slowing export expansion. This time imports also grew more quickly as non-oil import coefficients rose (domestic oil production had sharply cut the oil import coefficient), in response to a public sector investment programme aimed at breaking critical supply bottlenecks and to a previous import liberalization. Significant short and medium-term external

finance was successfully obtained in support of a major structural adjustment programme, the results of which are not yet all in place.

The prospects for the Indian economy through 1990, despite its relatively closed structure, depend significantly upon demand prospects for its exports and on the availability of external financing. The prospective decline in concessional assistance will increase debt servicing obligations and thus may unduly constrain future import capacity. Faster rates of export growth provide a potential way out of these difficulties but, with present projections of OECD growth, even the base projections of Indian exports imply substantially faster rates of their growth than of world trade. Accordingly, rates of GDP growth for the rest of the decade can be as great as those of the 1970s, only if more concessional finance can be obtained, or exports still more rapidly expanded, or if risks are taken in the accumulation of external commercial debt.

(c) Mexico (Zedillo, 1984)

The case study of Mexico's experience illustrates the possibility that domestic influences dominate external ones in the management of the balance of payments and overall macro-economic performance. From 1972 to 1976 the import content of both investment and consumption expenditures rose; external borrowing increased well beyond the requirements for financing the deficits on current account or governmental deficits, as capital flight gathered momentum. The external shocks of this period were extremely modest in the Mexican case (the terms of trade actually improved) and do not explain the steady deterioration in the current account. After a financial crisis, exchange rate devaluation and an IMF standby agreement in 1976 a rigorous stabilization programme reduced import coefficients and the current account deficit in 1977.

The new prospects of higher petroleum and natural gas exports combined with domestic political pressures generated a sharp expansion in government expenditure and overall economic activity again from 1978 to 1981. Import coefficients during this period rose higher than ever and the current account deteriorated rapidly once again. The public external debt did not grow as quickly in this period as the private debt, as all Mexican borrowers benefited from exuberant lender activity, improved credit ratings, and consequential reductions in spreads and longer maturities. Again, external "shocks" played a small part in the deterioration of the current account as Mexico experienced improvements in its terms of trade, more or less offset by increasing interest rates at this time. This short period of unprecedented growth was brought to an abrupt halt in 1981 in consequence of a decline in real oil prices, the growing realization of the unsustainability of Mexico's external position, and renewed capital flight. In early 1982 the currency was devalued, but excessive government expenditures continued unabated, capital flight resumed, and increasing difficulties were encountered in all but very short-term external borrowing. By August the "debt crisis" had arrived.

The subsequent dramatic adjustments hinged on drastic exchange rate devaluation and reduction of the government deficit. Sharp reductions (the



sharpest since the 1930s) in real gross fixed investment and GDP (25.3 and 4.7 per cent respectively) occurred, with particularly severe cuts in real wages. Imports dropped by 47 per cent in 1983 and the current account deficit was transformed into a surplus. This rapid turnaround - albeit at heavy short-term cost, and perhaps of limited political sustainability - was supported by substantial emergency short and medium-term external credit, the first of the famous "rescue packages". Current underutilization of domestic capacity cannot be directly attributed to foreign exchange scarcities resulting from external shocks, since it is so clearly the product of a stabilization programme made necessary by previous domestic overspending. The latter spending had been encouraged by perhaps somewhat over-enthusiastic external lending, that was eventually cut (indeed over-cut) to more reasonable levels; but such instability of external finance (while itself a genuine problem) is not the kind of external shock that analysts of recent shock experience have typically had in mind. In a diversified semi-industrialized economy that had become "overheated" the medium-term problem is better characterized as one of raising savings than of overcoming foreign exchange constraints (though the two are obviously related).

Mexico's prospects for the rest of the decade, after the severe adjustments of 1983/84, are heavily dependent upon both domestic and external events. Modest growth can be projected provided that the current stabilization programme "holds" (i.e. that current coefficients can be employed as the base for the purpose of making projections), that existing external debt can be rolled over or rescheduled (amortization payments now bunch ominously in the late 1980s) and that the overall external environment does not worsen. Obviously, there is no certainty that any of these conditions will be fulfilled, although much of the required debt rescheduling has been agreed. In the longer run, the security of stable supplies of external finance remains a paramount problem for a Mexican-type economy, at least as important as the more "conventional" external shock problems faced by other developing countries. As long as external commercial finance plays an important role in the overall economy and as long as it is capricious in its behaviour, the quality of domestic macro-economic management will carry implications for external balance that are much greater than in other developing economies.

The Mexican analysis shows that the most important elements in the 1982-1983 "success" story were, in order of importance: (i) import replacement; (ii) improved external conditions, especially reduced external interest rates; and (iii) domestic recession. Increased export competitiveness was, on balance, of relatively small significance - small gains from exports of manufactures were more than offset by losses on those of non-oil primary products, and the most important source of export improvement was the petroleum and natural gas industry, a rather special case. In terms of the usual orthodox canons of medium-term adjustment, Mexico was not as "successful" as is sometimes suggested. There must be doubt as to whether further import replacement is possible or even whether current coefficients are sustainable: some of the recorded "success" in this sphere was undoubtedly the result of stock reductions. Ultimately, export performance will have to improve substantially if present levels of austerity are not to endure. Mexico's problems are in that respect no different from those of other countries, and its performance so far, though improving, is less impressive than that of many others. Rather than responding to an external



shock the Mexican adjustment has primarily been a matter of restoring domestic macro-economic demand to sustainable levels. Is it for such efforts that it should deserve differentiated favourable treatment from international sources of finance?

It is striking that even the most dramatic "success story" of adjustment, an adjustment not to external shocks so much as to prior domestic overheating - that of Mexico - shows symptoms of an economy that remains vulnerable to the vicissitudes both of domestic performance and of the external environment.

(d) Philippines (Remolona, Mangahas and Pante, 1984)

The Philippines suffered severe external shocks from terms of trade deterioration and a decline of export volume in both periods, with the relative weight shifting from the former to the latter in the post-1979 period. These shocks were not as great in terms of GDP, however, as those encountered by the Republic of Korea. The 1973-1975 shock was successfully met through expanded external borrowing that made continued substantial investment and growth possible while new substitution for oil imports and policies for promoting non-traditional exports (including devaluation) gradually came to fruition. Savings rates rose during the 1970s but not enough to prevent a rapid accumulation of external debt.

The first response to the 1979-1980 shocks was a governmental attempt again to keep investment and growth programmes going. The import coefficient of spending other than that on oil or capital goods actually rose at the same time that aggregate demand expanded. In terms of our measurements, external shocks were less important than internal policies in "explaining" the deterioration in the current account until 1981. Until then, this optimistic policy response was again made possible by increased external borrowing. This time, however, investments did not prove as productive as previously and there was no simultaneous improvement in export or import-substitution performance. The current account continued to deteriorate, with external shocks becoming the dominant "explanatory" factor in 1982 and 1983. External finance was none the less sufficient to permit reserve accumulation. By late 1983, with limited evidence of appropriate adjustment policies or performance and new political uncertainties, external lenders halted further lending and called in much of their short-term credit which by now made up a significant proportion of the total Philippine debt. The resulting financial crisis is being dealt with by a drastic retrenchment in investment and output in order to restore the current account to reasonable levels. A gradual recovery from 1984's austerity levels will only be possible by means of increased exports and import substitution, especially as regards inputs. On the most optimistic assumptions regarding the speed of adjustment, the sustainability of domestic austerity, and the efficiency of investment, the recovery will not restore previous levels of GDP per capita until near the end of the decade. While there can be no denying that the economy's present problems are attributable largely to the miscalculations of Philippine policymakers regarding the likely length of the post-1979 recession and their failure to see the need for a greater adjustment effort in conjunction with the expansion of debt, the prospects for medium-term recovery are now primarily dependent upon external events. They are crucially dependent upon the continued availability of

finance and the avoidance of further external shock. For the next few years, output in the Philippines will, in any case, be constrained severely by the inadequacy of imports.

The case of the Philippines illustrates the possibility that external finance may merely postpone necessary adjustments in productive structure. For two years the Government led an investment boom in the apparent expectation that the recession would be short-lived. Moreover, import coefficients, other than those for oil and capital goods, actually rose during the post-1979 crisis. When finance subsequently dried up, the necessary adjustment had to be even more drastic. How serious the effects upon GDP and future growth are depends again upon how sharp the cuts in the current account deficit are and how quickly import substitution and export expansion policies can bear fruit. In the absence of other changes, some projections of immediate declines in the current account deficit imply initial cuts of output and consumption of 30 per cent and of investment by 45 per cent, with continuing declines thereafter (due to rising interest payments and therefore declining imports). With improvements both in export performance and in import substitution, recovery can resume after the initial blow of the sharp reduction in external financing; the timing and degree of the recovery are dependent upon the availability of external finance and other global conditions as well as, of course, on the extent of domestic improvement.

(e) Republic of Korea (Park, 1984)

The case of the Republic of Korea, that of another semi-industrialized economy, differs from that of Mexico in that it has encountered massive externally generated shocks. Its domestic macro-economic management has not been without difficulties but its record can be described as one of successful adjustment not to prior overheating but to external shock. This economy with its high export/GNP ratio, high import coefficients, and total dependence on imported oil, is extremely vulnerable to external shocks. In 1973-1975 it suffered an adverse external shock to its current account from changes in terms of trade and interest rate of an estimated 5.1 and 4.7 per cent (in 1974 and 1975 respectively) of potential GDP. In 1980 and 1981 the negative impact of shocks amounted to an even larger 7.5 and 9.8 per cent respectively, of what was by then a higher potential GDP, before dropping back to a still considerable 4.9 per cent in 1983. In the earlier standardized analysis expressing shocks as a proportion of actual rather than potential GDP and incorporating the effects of export volume decline - as reported in table 7 - these blows are recorded as even higher.

In the first shock episode, the Republic of Korea maintained its rapid growth while promoting faster export growth. Import volumes were not cut; indeed, import coefficients even rose despite heavy new taxes upon oil and devaluation, although some of the increase is attributable to the unusually high import-intensity of Korean exports. Within two years the increased competitiveness of exports had stimulated an export boom large enough to more than offset the increased imports implicit in continuing growth and increased import-intensity. This strategy was made possible through the country's access to substantial external credit, together with the use of its foreign exchange reserves. External finance was employed to stabilize domestic

investment programmes in the face of shocks to domestic income and therefore savings. It provided time for the necessary adjustments in productive structure to be made. In the opinion of the authorities, austerity and cuts in import volume would probably have prevented the realization of the export success which eventually substantially restored external balance.

The 1979-1983 experience was quite different. In the late 1970s the Government had followed a policy of encouraging a substantial expansion of investment in heavy and capital goods industries, financed primarily by increased external borrowing. (In this country, Government exercises virtually total control over access to and domestic allocation of external finance.) Increased debt, domestic inflation, declining prospects for exports together with political uncertainties had significantly reduced the country's ability to depend upon increased external finance. This time, therefore, in addition to devaluation and further increases in energy prices, macro-economic restraint was applied and was, in fact, the prime policy response to external shock. Some easing of external conditions, lowered oil-import coefficients, and continued access to external credit enabled the country relatively quickly to restore its healthy rate of growth (9.3 per cent in 1983) with external balance. Its continued underutilization of capacity is at present judged by the author of the country study to be attributable primarily to inefficiency and previous over-investment in heavy industry rather than to a foreign exchange constraint.

Assuming that the Republic of Korea achieved capacity utilization in 1978 (implying 87 per cent utilization in 1983), and with a range of reasonable assumptions as to world conditions and domestic performance, including a sharp increase in the savings rate, the Bacha model predicts that it too will nevertheless operate under a foreign exchange constraint during the 1980s. Korean policymakers do not perceive their economy as constrained by foreign exchange availability so much as by domestic saving (and the efficiency of investment), since they consider that external finance is always available to them in the amounts that they are likely to require. The Government's efforts to expand exports and save on imports are no less determined, however, than those of other countries which do perceive themselves as foreign exchange constrained.

Medium-term projections of the country's economic growth are quite optimistic, being based on further increases in what is already a very high domestic savings rate and continued rapid expansion of exports. External capital is regarded as a residual for making up any unplanned deficiencies in savings, and its relative role is projected as declining. The economy none the less remains very vulnerable to external events. Essential imports (oil, grains, and raw materials for the export sector) together with debt servicing obligations at present account for 80 per cent of total exports. As in the past, external shocks such as terms-of-trade deterioration, cutbacks or cost increases in foreign borrowing (much of which is now short-term) would have a severe macro-economic impact on the country. Unambiguous short-term foreign exchange constraints would soon materialize in such circumstances.

The case of the Republic of Korea illustrates the need both for an adequate flow of external finance and for structural adjustment to



unfavourable external developments. As has been seen, were the expected flow of external finance to be severely cut, as it has been or threatens to be in the Philippines, Brazil and other countries, the Republic of Korea would, like them, face severe output and investment cuts in the short to medium term.

(f) Zimbabwe (Green and Kadhani, 1984)

Analysis of the Zimbabwe experience is complicated by the fact of a major political change - independence - in the middle of the period under study. The response of the then white minority regime to the external shocks of 1973-1974 primarily took the form of macro-economic restraint and tightened import controls. Opportunities for export expansion were somewhat constrained by sanctions against the regime. Towards the end of the civil war, further war-generated pressures placed additional strains upon an already strained economy. GDP and gross fixed investment declined steadily from 1974 until independence in 1980.

Independence brought the launching of an expansionist push by the new Government. A once-for-all improvement in the terms of trade resulting from the cessation of sanctions, increased capital inflows, the availability of substantial excess capacity, and good weather combined to conceal the symptoms of macro-economic imbalances, as Zimbabwe realized boom conditions in 1981. External events were already causing terms of trade to worsen in 1981, however, and the deterioration continued for the next three years. At the same time successive droughts in 1982, 1983 and 1984 severely damaged the agricultural sector. And concessional capital inflows failed to approach the expected levels.

Major adjustment was required and, as in the 1974/75 period, it took the form primarily of macro-economic restraint and rationalized foreign exchange controls. This time, however, through devaluation and selective foreign exchange allocation, the Government actively sought to expand exports at the same time that imports were severely cut. Import coefficients are already low for a small primary exporting country and cannot easily be reduced much further. At the same time investment, in export-oriented facilities as well as in others, is highly import-intensive. Medium-term adjustment therefore depends upon expanded exports, and this expansion is possible only through increased availability of imported materials and capital goods. In a post-independence period, and since GDP has still not regained the levels of 1974 (although interracial distribution of income has undoubtedly improved), there are also limits to the degree of austerity that is politically acceptable. The Zimbabwe economy is thus at present unambiguously foreign exchange constrained, rather than capacity constrained. Projections of modest growth depend crucially upon the rate of growth of exports and the avoidance of further external shocks. Zimbabwe's prospects of obtaining increased external finance are not particularly bright, and its position illustrates the adjustment problems of middle-income developing countries that are neither poor enough to attract expanded official development assistance nor creditworthy enough to attract commercially-motivated finance. In Zimbabwe, the elimination of the current account deficit by 1986 - a target that has been seriously discussed - would imply a massive cutback of about two-thirds in gross fixed capital formation in the first year, together with a cutback of



20-25 per cent in real consumption and real output per capita. If these targets could be attained - and there must be serious doubt whether they are socially and politically as well as technically realizable - the economy could still subsequently run into further difficulties in maintaining exports and containing inflation as maintenance of existing capital stock and failure to expand supply capacity took their toll. In the best of circumstances, output by 1990 would be lower by 3-5 per cent and cumulative output from 1984 to 1990 by 7-10 per cent relative to the outcome achievable if the current account deficit can continue to be financed at 1983 levels. (The latter scenario still requires significant reductions in per capita consumption and output in the first two years.) If the current account deficit must be reduced, a more gradual reduction is far less costly, disruptive and risky than a sharp and sudden reduction.

(g) Ivory Coast

In the study of the Ivory Coast (Ouattara), it was not possible to employ fully comparable methodologies in the analysis of recent external shock and responses to them, because the relevant data could not be brought up as far as 1981.

6. SUMMARY AND CONCLUSIONS

The severe external shocks of recent years reduced incomes and output and gave rise to foreign exchange shortages in the majority of developing countries. In addition to a deterioration in their terms of trade, a decline in their export volume, and an increase in real interest rates on external debt there was a sharp decline in the flow of capital to many of these countries. Import volumes virtually everywhere were forced to contract, in some instances by remarkable proportions. These import cutbacks were associated with declines in the utilization of existing productive capacity and even sharper declines in investment, with the consequence that prospects for future growth were gravely impaired.

The developing countries affected undertook major adjustments in response to these external events. Any remaining "slack" in the import bill was quickly chopped away. Import substitution was encouraged and exports were expanded, both stimulated by extensive restructuring of incentives achieved through exchange rate devaluation and other devices. These restructuring efforts take time and they are continuing. Where they were insufficient to balance external accounts, i.e. where imports still were larger in value than the economies' capacity to pay for them, output, expenditures and income had to be cut as well. The less the short-term adjustment capacity of the productive structure, the greater was the need for cutbacks in overall demand, investment, output and income.

In the majority of developing countries output remains below the level that larger foreign exchange earnings would almost immediately permit. More important for the longer run, foreign exchange shortfalls also continue to constrain investment and limit the growth of future capacity, if vigorous and

sustained recovery in global economic conditions was achieved in the next few years the capacity of many developing countries to respond would therefore be limited. If, however, there has been a long-term worsening in the developing countries' prospects for foreign exchange availability, the implications for output, income, employment and growth in these countries over the medium and longer term depend fundamentally upon what restructuring investment is undertaken at present. Either way, there will be serious medium- to long-run consequences for developing countries from the current foreign-exchange constrained levels of investment.

Moreover, conventional macro-economic accounting may seriously understate the degree to which recent austerity (cutbacks in investment and GDP) reduces future output, welfare and growth. It is clear enough that cutbacks in investment programmes are bound to have future implications. It is not always realized, however, that many current expenditures also affect, for better or for worse, the welfare of future generations. In particular, expenditures upon child welfare, health, nutrition, education, and for like purposes significantly influence the productivity of future generations. Cutbacks in such "productive" social expenditures may be far more socially costly than cutbacks in many types of investment as it is conventionally defined. The future costs of such cutbacks are likely to be highest where levels of living, particularly those of children, are already very low and where nutrition, health and productivity are peculiarly vulnerable to further cuts in income. In a prescient section of its 1979 World Development Report the World Bank warned, with special reference to Sub-Saharan Africa, of the

"serious danger that economic stringency in the next few years will lead to cutbacks in human development programs, despite the importance of their contribution - often exceeding that of additional physical investment - to...long-term development potential." (p. 86)

UNICEF has recently documented some of the effects of the global recession upon the welfare of children (UNICEF, 1983 and Jolly and Cornia, 1984). An increased incidence of malnutrition, reduced birth-weight and height-for-age, and higher mortality rates have been recorded in particularly severely affected areas. The evidence also ominously suggests that there may be a considerable time lag between initial economic shocks and the full eventual effect upon children's health and welfare; presumably, there may then be an even longer lag between the shock and the effects upon overall growth and welfare.

In national-level simulations of the prospects for the 1984-1989 period, the severe implications for output, investment and future growth of achieving quick reductions in deficits in the current account of the balance of payments in relatively rigid economies are dramatically evident. It is also striking that, in these projections, the foreign exchange constraint, rather than the savings constraint, binds growth in a wide variety of developing countries over the course of the next five years. The need to service debt, rebuild a depreciated capital stock, and restore foreign exchange reserves, in the face of the global prospect as most now see it, implies not only very modest progress in output, income and employment but also continuing underutilization of capacity attributable to import constraints. Unexpected external shocks would quickly create similar problems for those countries that still consider themselves unconstrained by foreign exchange shortages.

Despite considerable efforts at restructuring and restraint, underlying rigidities cannot so rapidly be overcome. The application of sheer macro-economic restraint for the purpose of achieving medium-term external balance objectives is shown, particularly in the dramatic Brazilian case, to imply very high longer-term costs. By implication, the provision of finance to permit a longer period of structural adjustment is, in every case, likely to be highly productive.

The lessons are straightforward ones. Most of the developing countries have undertaken significant restructuring so as to improve export performance and substitute for imports. Efforts in this direction are continuing but they take some time to produce their full effects. Even in the better-off and the more diversified of these countries the extent to which such structural adjustment can be achieved within a relatively short period is limited. Virtually all oil-importing developing countries have therefore also been forced to contract aggregate demand, particularly investment, and output in order to attain short- to medium-term external balance. The costs of this contraction in terms of forgone output and future growth are significant. They will not be fully evident for some time to come and they will be manifest not only in lower physical capacity to produce but also, and more tragically, in unnecessarily stunted human potential.

Some part of these costs may have been inevitable as shocks of unprecedented size and duration came upon a world that was unprepared to deal with them. Offsetting or modifying credits were not at first available in sufficient volume to prevent them. But several years have now elapsed. The evidence of the high costs of inadequate credit now exists. So does the evidence of what determined efforts at domestic restructuring can accomplish, as well as the evidence of the limits to what can be accomplished within a short space of time even in relatively advanced economies. Moreover, there is now something of a consensus as to what changes in global conditions are more or less irreversible in the medium term. The terms of trade for oil-importing developing countries are not expected to regain previous peaks for some time, real interest rates are now expected to remain high, the aggregate growth of the industrial countries is expected to remain modest. It is also expected that primary commodity markets, interest rates and exchange rates will remain considerably more unstable in the 1980s than they were in the 1950s and 1960s.

The need for more adjustment finance, both immediately for those now being forced to curb demand for the sake of short-term balance-of-payments objectives, and to ease future balance-of-payments shocks, could scarcely be clearer.

The mere provision of increased external finance will obviously not prove productive if the time that it buys is not well employed. This analysis suggests that levels of external finance higher than are now in prospect can, on reasonable assumptions as to domestic economic management, generate much improved economic performance, not that they necessarily will. The evidence of recent years suggests, however, that in the majority of cases appropriate adjustment has been taking place and that it will continue to occur. It would be foolish to exaggerate the importance of the relatively few cases of failure

to adjust, as plans are made for appropriate levels of short-term to medium-term official finance for developing countries in the remainder of the 1980s.

Balance in external payments over some particular time period has never been an end in itself. Rather, the requirement of external balance should be seen as constraining the possibilities with respect to more important ultimate objectives - national income and welfare, employment, growth, etc. Where possible, such current account imbalances as can be financed should be phased so as not to impair the attainment of the latter objectives. External finance should itself be made available and phased so as to respond to broad systemic needs and agreed overall objectives. It is false economy for over-cautious creditors so to restrict their finance as to force debtor nations unduly to deflate and/or restrict outward payments. Such restraint may have severe adverse implications not only for the directly affected developing countries but also for the entire world economy. The very high returns demonstrated above from the provision of increased foreign exchange in some developing countries, particularly in Brazil which has the largest external debt of all, implies higher feedback effects upon overall growth in the world economy than those that earlier global models not incorporating this fact have suggested.

So-called "adjustment", that restores external balance by abandoning ultimate objectives, is not so much adjustment as retrenchment. Nor is adjustment assisted by "forced" and "involuntary" private lending a desirable or sustainable mode of adjustment. It is the function of governments and of the multilateral financial institutions, by timely and selective injections of international credit, to promote the achievement of the ultimate welfare objectives and, where possible, to restore the voluntary and efficient working of global financial markets. There are many ways in which short-term and medium-term official international finance can be expanded as required. At present the most straightforward ways are probably the restructuring of international debt and an expansion of the lending activities of the IMF and the World Bank. Improved compensatory financing arrangements - expanded to allow for changes in import prices and interest rates, permanent or long-term shifts, and increased volumes of credit when needed - are an obvious joint objective for IMF and World Bank credit expansion. Precisely how these objectives can best be pursued must be for others to elaborate. This study has focussed on establishing the need rather than on the best means of satisfying it.



APPENDIX TABLESDECOMPOSITION OF SOURCES OF EXTERNAL SHOCK AND DOMESTIC  
POLICY RESPONSE IN 25 DEVELOPING COUNTRIES\*

(expressed as percentage of actual GNP)

Table 1 - 1973-75

Table 2 - 1973-78

Table 3 - 1978-81/82

\*Footnotes and a methodological note by Edmar Bacha and Luiz Avila follow the tables.

Table 1

1973-75	EXTERNAL SHOCKS <sup>1</sup>				DOMESTIC POLICY ACTIONS <sup>3</sup>				Residual				
	Observed Deficit Increase	Terms of Trade			Interest Rate	World Trade	Other <sup>2</sup> External Variables	Domestic Spending <sup>4</sup>			Trade Ratios <sup>6</sup>		
		Total	Gross Investment	Consumption				Export Ratio		Import Ratio			
											Total		
1. Argentina	2.8	0.6	0.1	0.0	0.4	-0.1	2.2	-0.0	0.2	1.0	1.0	0.1	
2. Brazil	3.2	1.6	0.2	0.3	1.1	0.2	1.5	0.2	0.1	0.8	0.4	-0.1	
3. Chile	3.1	17.9	18.5	2.7	-3.3	0.6	-17.8	0.0	-3.4	-8.0	-6.5	2.5	
4. Colombia	0.1	3.4	1.7	0.2	1.5	-0.4	-3.0	-0.0	-0.2	0.3	0.3	-0.0	
5. Costa Rica	2.9	6.6	4.1	0.4	2.2	0.1	-3.8	-0.7	0.3	-1.5	-1.9	0.0	
6. Dominican Republic	-2.2	-7.7	-11.5	1.0	2.8	-1.1	6.5	0.9	1.2	0.5	3.9	0.1	
7. Egypt	11.8	10.0	7.7	0.3	2.0	-4.3	6.4	4.2	-1.8	-3.6	7.6	-0.3	
8. India	-0.0	3.3	2.8	-0.1	0.5	-0.5	-2.9	-0.1	-0.0	-1.9	-1.4	0.1	
9. Indonesia	0.8	-5.6	-8.0	0.0	2.4	1.1	5.3	0.9	1.1	-0.8	4.1	0.1	
10. Ivory Coast	-6.6	9.6	5.4	0.2	4.0	-5.7	-10.6	0.0	-3.1	-4.4	-3.1	-0.0	
11. Korea, Rep. of.	7.0	8.5	4.7	-0.3	4.1	1.5	-3.0	0.8	-0.1	-3.4	-0.3	0.0	
12. Mexico	1.8	0.4	-0.6	0.1	0.8	0.0	1.5	0.2	0.0	0.7	0.5	-0.0	
13. Morocco	7.1	-0.1	-3.4	-0.0	3.3	-2.0	9.7	2.6	-0.4	5.7	1.8	-0.4	
14. Pakistan	7.5	7.5	6.5	0.0	0.9	-0.9	0.9	-0.1	0.2	1.0	-0.3	0.0	
15. Peru	8.1	7.6	6.2	-0.1	1.4	-0.1	0.6	0.5	-0.3	-0.6	1.0	-0.0	
16. Philippines	10.6	5.6	3.0	0.2	2.4	-0.1	5.1	1.7	-0.3	2.7	0.9	-0.1	
17. Sri Lanka	4.0	12.3	10.7	-0.0	1.7	-2.3	-6.1	0.5	-1.8	-3.0	-1.9	0.1	
18. Sudan	10.8	5.4	2.3	-0.2	3.2	-0.8	6.5	1.1	0.9	4.9	-0.5	-0.2	
19. Tanzania	2.0	4.6	3.4	-0.1	1.3	-3.7	1.2	-0.2	0.9	2.6	-2.1	0.0	
20. Thailand	3.6	7.5	5.1	-0.0	2.3	0.7	-4.6	0.1	-0.7	1.1	-5.2	0.1	
21. Turkey	6.0	3.7	2.7	0.0	1.0	0.3	2.0	0.7	-0.2	1.2	0.4	-0.0	
22. Uruguay	6.9	11.6	10.1	0.5	1.1	1.5	-6.2	0.4	-0.9	-5.3	-0.4	-0.1	
23. Venezuela	-2.4	-17.7	-26.1	2.6	5.7	-6.6	24.1	0.5	2.2	16.8	4.6	-2.1	
24. Zaïre	15.4	16.4	18.3	-0.8	-1.0	1.4	-2.9	0.2	-1.6	5.1	-6.7	0.4	
25. Zambia	37.6	35.2	35.7	-2.6	2.2	1.7	0.6	0.5	0.2	-1.0	0.8	-0.0	

Table 2

1973-78	EXTERNAL SHOCKS <sup>1</sup>				Other 2 External Variables	DOMESTIC POLICY ACTIONS <sup>3</sup>						Residual
	Observed Deficit Increase	Terms of Trade				Total	Domestic Gross Investment	Spending <sup>4</sup>		Trade Ratios <sup>6</sup>		
		Interest Rate	World Trade	Other 2 External Variables				Consumption	Export Ratio	Import Ratio		
1. Argentina	-1.5	1.9	3.2	0.1	-1.4	-0.3	-2.7	0.1	-0.4	-2.5	0.2	-0.5
2. Brazil	1.4	1.2	0.1	0.3	0.9	1.2	-0.9	-0.2	0.4	0.5	-1.5	-0.0
3. Chile	2.8	16.3	15.9	2.6	-2.2	-2.5	-9.5	0.5	-2.9	-9.3	2.1	-1.4
4. Colombia	-2.0	-0.9	-2.4	0.3	1.2	-1.1	-0.1	0.5	-0.4	-2.0	1.8	0.2
5. Costa Rica	2.0	-2.8	-5.3	0.7	1.8	-0.5	5.1	1.3	1.6	-2.1	4.2	0.2
6. Dominican Republic	2.5	5.5	2.5	2.2	0.8	-5.0	1.5	0.3	0.2	-0.2	1.2	0.5
7. Egypt	12.1	14.9	8.6	0.7	5.6	2.6	-5.2	1.8	-4.0	-5.0	2.1	-0.2
8. India	-1.6	1.4	1.1	-0.0	0.3	-1.3	-1.7	0.1	-0.2	-1.5	-0.1	0.0
9. Indonesia	-0.2	-6.8	-9.7	0.0	2.8	0.5	5.6	1.4	0.9	-2.0	5.4	0.5
10. Ivory Coast	-3.1	-3.7	-9.8	0.4	5.6	-3.4	3.9	5.1	-1.2	-1.3	1.3	0.2
11. Korea, Rep. of.	-0.0	8.2	-1.3	-0.0	9.5	0.3	-7.6	3.4	-2.6	-19.8	11.4	-0.9
12. Mexico	0.2	0.2	-0.3	-0.1	0.6	0.8	-0.8	0.1	-0.1	-1.0	0.2	0.0
13. Morocco	11.3	4.4	1.9	0.4	2.1	-1.1	8.3	1.6	0.6	4.8	1.3	-0.3
14. Pakistan	0.5	3.1	2.3	0.2	0.6	-5.7	3.3	-0.2	0.2	2.4	0.9	-0.2
15. Peru	-0.2	3.2	5.9	-1.1	-1.6	4.1	-9.3	-1.1	-0.1	-1.7	-6.5	1.8
16. Philippines	10.0	7.3	4.9	0.4	2.0	0.6	2.1	1.7	-0.8	-0.1	1.3	-0.0
17. Sri Lanka	2.9	-3.0	-4.2	-0.1	1.3	-0.6	8.3	2.1	-0.5	23.5	-16.9	-1.8
18. Sudan	7.4	3.8	-0.6	-0.5	4.9	-0.9	4.3	0.5	1.2	5.0	-2.4	0.2
19. Tanzania	4.0	-3.6	-3.4	-0.1	-0.1	-3.7	11.6	0.2	2.2	12.7	-3.6	-0.2
20. Thailand	4.2	10.6	7.3	0.2	3.2	1.7	-8.2	0.8	-1.4	-4.4	-3.2	0.1
21. Turkey	1.7	3.0	2.3	0.1	0.6	0.2	-1.8	0.5	-0.4	1.8	-3.7	0.3
22. Uruguay	4.9	11.3	11.3	0.3	-0.3	0.9	-6.5	1.6	-2.4	-6.8	1.0	-0.8
23. Venezuela	19.2	-11.7	-20.1	4.4	3.9	-7.1	42.3	3.3	4.2	22.3	12.5	-4.2
24. Zaire	-1.6	5.8	16.3	-2.2	-8.3	1.6	-10.6	-2.5	-6.9	11.2	-12.5	1.6
25. Zambia	16.7	29.9	41.1	-5.1	-6.1	1.4	-15.9	-6.1	-2.0	5.0	-12.9	1.3

Table 3

1978-82 (Unless specified otherwise)	EXTERNAL SHOCKS <sup>1</sup>				Other 2 External Variables	DOMESTIC POLICY ACTIONS <sup>3</sup>						Residual
	Observed Deficit Increase	Terms of Trade				Total	Gross Investment	Domestic Spending <sup>4</sup>		Trade Ratios <sup>6</sup>		
		Total	Interest Rate	World Trade				Consumption	Export Ratio	Import Ratio		
1. Argentina	8.5	-0.9	-0.5	1.5	-1.9	6.9	3.2	-0.4	0.9	0.7	2.0	-0.7
2. Brazil	2.7	4.4	2.5	1.5	0.4	1.7	-3.2	-0.4	-0.0	-1.7	-1.1	-0.1
3. Chile	5.2	3.8	1.6	3.2	1.6	3.3	-2.0	-1.3	1.7	-5.0	2.6	0.1
4. Colombia	6.6	3.7	2.2	0.6	0.9	-0.6	3.4	0.6	0.1	1.8	0.8	0.1
5. Costa Rica						N.A.						
6. Dominican Republic	-0.3	4.6	1.5	1.2	1.8	0.7	-5.2	-1.0	1.1	-0.8	-4.5	-0.3
7. Egypt - 1981	-3.6	-0.9	-3.5	-0.5	3.1	-4.4	1.8	1.1	3.0	-5.0	2.7	-0.1
8. India - 1981	2.4	1.5	1.4	0.0	0.0	-0.7	1.6	0.0	0.1	-0.8	2.4	-0.0
9. Indonesia - 1981	-1.7	-14.1	-18.4	-0.0	4.4	-0.2	13.2	0.3	3.3	4.6	4.9	-0.7
10. Ivory Coast						N.A.						
11. Korea, Rep. of.	1.5	9.2	6.2	0.7	2.3	1.3	-8.8	-2.2	0.7	-7.2	-0.2	-0.2
12. Mexico	-3.7	-0.9	-5.5	2.1	2.5	1.6	-4.2	-0.1	0.3	-4.8	0.3	-0.1
13. Morocco						N.A.						
14. Pakistan	0.8	7.6	6.0	-0.1	1.7	-1.3	-5.4	-0.1	-0.1	-2.9	-2.3	-0.1
15. Peru	5.0	-1.6	-3.7	1.0	1.2	-1.3	8.2	0.8	0.4	1.1	5.9	0.5
16. Philippines	3.0	4.8	2.2	0.6	2.0	1.1	-2.8	-0.3	0.2	-2.9	0.2	-0.1
17. Sri Lanka	7.6	65.9	59.9	0.4	5.6	-7.1	-57.9	5.7	-10.1	-11.4	-42.1	6.6
18. Sudan - 1981	1.7	-1.3	1.1	-1.5	-0.9	-0.7	3.5	0.2	0.4	-1.3	1.8	0.2
19. Tanzania - 1981	-3.0	8.9	8.8	0.2	-0.1	1.0	-12.7	0.4	-2.6	-5.4	-5.2	-0.2
20. Thailand	-3.4	9.5	6.1	0.3	3.2	0.3	-13.2	-1.7	0.4	-8.8	-3.2	-0.0
21. Turkey - 1981	0.3	4.7	4.5	0.5	-0.4	-1.8	-2.5	-0.5	0.2	-3.6	1.4	-0.0
22. Uruguay - 1981	0.4	0.7	-0.1	0.2	0.5	-0.9	0.5	0.2	0.1	-2.0	2.3	0.1
23. Venezuela	-9.2	-13.2	-11.4	0.1	-1.9	1.5	2.8	-3.0	2.0	6.8	-3.1	-0.4
24. Zaire						N.A.						
25. Zambia	6.3	10.0	15.7	-2.6	-3.2	-0.8	-3.2	-6.3	8.7	8.6	-14.2	0.2



Notes:

1. A positive sign denotes an adverse external shock, such as a terms-of-trade deterioration, an interest rate increase, or a deceleration of world trade. A negative sign denotes a favourable external shock.
2. A positive sign denotes an unfavourable movement of other external variables, such as a net accumulation of foreign indebtedness between the beginning and the end of the period. A negative sign denotes a favourable movement of other external variables.
3. A positive sign denotes a deficit-increasing policy action. A negative sign denotes a deficit-reducing policy action.
4. A positive sign denotes an expansion of domestic spending, which increases the deficit. A negative sign denotes a contraction of domestic spending, which reduces the deficit.
5. A positive sign denotes a movement of the trade ratios which increases the deficit. A negative sign denotes that the trade ratios moved to reduce the deficit.
6. A positive sign denotes a reduction of the exports to world trade ratio. A negative sign denotes an increase of the export ratio.
7. A positive sign denotes an increase of the import content of domestic spending. A negative sign denotes a reduction of the import ratio.

METHODOLOGICAL NOTE

(L. Avila and E. Bacha)

The decomposition of the deficit on current account

The current account deficit (including unrequited transfers) at time  $t$ , in domestic currency, is initially expressed as the difference between imports of goods and non-factor services (NFS),  $M$ , plus net factor services to abroad,  $V$ , and exports of goods and NFS,  $E$ , plus net unrequited transfers from abroad,  $T$ :

$$D(t) = M(t) + V(t) - E(t) - T(t) \quad (1)$$

Imports and exports are then expressed as the product of price and volume indices (the latter in constant 1975 domestic currency prices):

$$M(t) = P_m(t)J(t) \quad (2)$$

$$E(t) = P_x(t)X(t) \quad (3)$$

Data are not generally available for a decomposition of import coefficients. Hence, an overall coefficient ( $j$ ) is assumed to relate the import volume to real domestic absorption ( $A$ ), which is divided into real consumption plus real gross domestic capital formation:

$$J(t) = j(t)A(t) \quad (4)$$

$$A(t) = C(t) + I(t) \quad (5)$$

An overall export coefficient relates the export volume to the real value of world trade ( $W$ ):

$$X(t) = x(t)W(t) \quad (6)$$

Net factor services to abroad are divided into net interest to abroad ( $V_i$ ), other net investment income to abroad ( $V_d$ ), and net workers' remittances from abroad ( $R$ ). Net interest, in domestic currency, is then expressed as the product of the current dollar interest rate (per cent per year) ( $r$ ) multiplied by the net stock of foreign debt at the end of the previous year ( $F$ ) (with the latter expressed in domestic currency by use of the current year average domestic currency/dollar exchange rate):

$$V(t) = V_i(t) + V_d(t) - R(t) \quad (7)$$

$$V_i(t) = r(t)F(t-1) \quad (8)$$

If (2) to (8) are substituted in (1) and the result divided by GNP in current domestic currency prices (division by potential GNP not being possible owing to lack of appropriate data), there results:

$$\begin{aligned} D(t)/Y(t) &= j(t)p_m(t)(C(t)/Z(t) + I(t)/Z(t)) \\ &+ r(t)F(t-1)/Y(t) + V_d(t)/Y(t) - R(t)/Y(t) \\ &- x(t)p_x(t)W(t)/Z(t) - T(t)/Y(t), \end{aligned} \quad (9)$$

where national income in current prices is equal to the product of real national income and the implicit deflator of GDP:  $\underline{1/}$

$$Y(t) = P_Y(t)Z(t) \quad (10)$$

and where:

$$p_m(t) = P_m(t)/P_Y(t) \quad (11)$$

$$p_x(t) = P_x(t)/P_Y(t) \quad (12)$$

All nominal variables in (9) except for  $Y(t)$  were originally expressed in dollars, being converted into domestic currency by use of observed exchange rates. Hence, the ratios involving nominal variables in (9) are affected by abrupt changes in the real exchange rate. To overcome this problem, the calculations were also undertaken with a revised GNP deflator that allowed for the effects of changes in real exchange rates, by multiplying  $P_Y(t)$  by an index of the latter. This procedure did not significantly alter the overall results.

The final formula, as expressed in Appendix tables 1-3, is obtained taking first differences in equation (9):

$$\begin{aligned} d(D(t)/Y(t)) &= (j(s)(C(s)/Z(s))dp_m(t) - x(s)(X(s)/Z(s))dp_x(t)) \\ &+ F(s-1)/Y(s)dr(t) - x(s)p_x(s)d(W(t)/Z(t)) \\ &+ r(s)d(F(t-1)/Y(t)) + d(V_d(t)/Y(t)) \\ &- d(R(t)/Y(t)) - d(T(t)/Y(t)) \\ &+ j(s)p_m(s)d(C(t)/Z(t)) + j(s)p_m(s)d(I(t)/Z(t)) \\ &+ p_m(s)(A(s)/Z(s))dj(t) - p_x(s)(W(s)/Z(s))dx(t) \\ &+ \text{interaction terms} \end{aligned} \quad (13)$$

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$\underline{1/}$  Equation (10) does not hold exactly, because  $P_Y$  is the implicit GDP deflator, not the implicit GNP deflator. However, the error involved in this approximation proved to be very small in the following exercises.

where the symbol 'd' before a variable indicates the change in the value of this variable between each year in the 1973-78 (or 1978-82) period and the 1973 (or 1978) base year, and where the symbol 's' indicates the year for the weights of the decomposition terms. Equation (13) was calculated three times, 's' being respectively the current year, the base year, and a simple average of the two. The results reported above are those employing the average of the current year and the base year.

With the changes of signs appropriate to their denomination, the terms in (13) are identified in worksheets by the following expressions:

variation in the current account deficit ratio to GNP between final year and base-year (1973 or 1978) = terms of trade deterioration + interest rate shock + retardation of world trade growth + burden of debt accumulation + change in direct investment income - change in workers' remittances - change in unrequited transfers + consumption contraction + investment reduction + import replacement - export penetration + interaction effects and adding-up errors.

In the tables presented here, the burden of debt accumulation and the changes in direct investment income, workers' remittances and unrequited transfers were consolidated as "Other External Variables".

#### Symbols and data

The data for the variables entering equations (1) to (10), with the exception of world trade, came from Data Sheets I and II of World Bank, World Tables, 2nd and 3rd Editions, plus a special tabulation for 1982 kindly provided by the Bank. 2/ They are as follows:

- M - Imports of goods and NFS at current domestic currency prices (DCP).
- V - Factor payments to abroad (net) at DCP. In most cases, this was taken directly from Data Sheet I. However, in a number of cases, a check with the item 'net factor service income from abroad', in dollars, in Data Sheet II, suggested that the values in Data Sheet I excluded workers' remittances from abroad. In these cases, the item 'workers' remittances', in Data Sheet II, multiplied by the average dollar exchange rate, was subtracted from the value for factor payments presented in Data Sheet I.
- E - Exports of goods and NFS at DCP.
- T - Net current transfers from abroad at DCP. Calculated as the difference between gross national savings including net current transfers from abroad and gross national savings excluding such transfers at DCP. The value of T in domestic currency,

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2/ The 1982 Brazil data are of a preliminary nature and were derived from Brazilian sources.



implicitly presented in Data Sheet I, was calculated by the World Bank by multiplying the dollar value of 'net unrequited transfers' (in Data Sheet II) by the average domestic currency/dollar exchange rate. Hence, T does not include the value of 'workers' remittances', which appear in Data Sheet II as part of 'net factor service income', not as part of 'net unrequited transfers'.

- D - Current account deficit including transfers at DCP. Calculated according to equation (1).
- J - Imports of goods and NFS at 1975 domestic currency prices (75DCP).
- X - Exports of goods and NFS at 75 DCP.
- $P_m$  - Domestic current price index of imports, with 1975=1.0. Calculated according to equation (2).
- $P_x$  - Domestic currency price index of exports, with 1975=1.0. Calculated according to equation (3).
- j - Import content of domestic absorption at 75DCP. Calculated according to equation (4).
- C - Sum of government and private consumption at 75DCP.
- I - Gross capital formation at 75DCP.
- A - Gross domestic absorption at 75DCP. Calculated according to equation (5).
- W - GATT volume index of world exports, expressed in 1975 dollars, and converted to 1975 domestic currency prices by use of the average domestic currency/dollar exchange rate for 1975.
- x - Market share in world exports at 75DCP. Calculated according to equation (6).
- $V_i$  - Net interest payments to abroad in DCP. With one exception, this was calculated multiplying the item 'others' of 'net factor service income from abroad' in current dollars in Data Sheet II by the average domestic currency/dollar exchange rate. In the case of Tanzania, a clear distinction could not be made between interest and profit in the balance of payments data. Hence,  $V_i$  in this case was equated to the product of 'interest payment' on external public debt (also in Data Sheet II) and the average domestic currency/dollar exchange rate.
- R - Net workers' remittances from abroad at DCP. This was calculated multiplying the item 'workers' remittances' in current dollars (Data Sheet II) by the average domestic currency/dollar exchange rate.
- $V_d$  - Net direct investment income to abroad at DCP. This was calculated as the residual in equation (7).

- r - Dollar rate of interest. Calculated implicitly as the ratio between interest payments in year  $t$  and debt outstanding - disbursed at end of year  $t-1$ , presented in Data Sheet II. These data relate only to public and guaranteed private debt; hence, the calculated 'r' may both underestimate and vary less than actual 'r' in the case of countries with large non-guaranteed private debt.
  
- F - Net foreign debt at end of year  $t-1$ , expressed in domestic currency by use of the average domestic currency/dollar exchange rate in year  $t$ . Calculated implicitly using equation (8).
  
- Y - GNP at DCP.
  
- Z - GNP at 75DCP.
  
- $P_y$  - Implicit GDP deflator.

Thirty countries, ten each of Latin America, Africa and Asia, were initially selected for the exercise. Data difficulties forced the exclusion of some of these.

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ANNEX

Terms of reference for the country studies

by

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## 1. Introduction

The studies prepared in connection with this project are intended to provide material for the Group of 24 in its continuing dialogue with the developed market-economy countries in the International Monetary Fund (IMF) concerning the nature and causes of developing countries' external-payments difficulties and the appropriate national and international policies for alleviating them. For this purpose there will be a number of country studies together with a report which will synthesize the conclusions that may be drawn from this examination of experience at a national level. It is to be hoped that among the topics to which these studies will draw special attention will be the interaction of changes in the external economic environment and the range of policy options available to developing countries on the one hand, and the implications for future growth and development of many of the policies adopted in such countries in response to recent economic pressures on the other. There is now widespread acknowledgement of the need for improved policies and management in developing countries, but less attention has been paid to the implications of the deterioration of the external economic environment for the nature of, and scope for, such improvements.

The prospects of developing countries will be crucially affected by current trends in their rates of investment. There is much evidence that investment in many of these countries has been seriously impaired since the onset of the current crisis. A major objective of the studies will be to document this impairment in detail and to consider how it affects the development of the countries concerned.

The central objectives of the countries studies can be more specifically described as follows:

- (i) To summarize the macroeconomic experience of the country since the early 1970s, with emphasis on the interrelationships of external shocks, balance-of-payments difficulties and domestic policy actions and responses;
- (ii) To document the impact of the external shocks in the 1970-1982 period on the foreign-exchange situation and adjustment needs of the country in the early 1980s;
- (iii) To assess the country's effort to achieve a balance-of-payments adjustment in the 1979-1983 period;
- (iv) To evaluate the extent to which the country's response to these balance-of-payments difficulties, frequently in the form of the austerity programmes adopted, may be causing not only a temporary loss of output but also more permanent damage to its growth prospects; and

- (v) To suggest forward-looking, empirically-based policy alternatives for the process of macroeconomic adjustment in the country.

The country studies will be partly based on data of a systematic kind, such as national accounts and balance-of-payments figures, for the purpose of illuminating the impact of economic policy and other influences on the economy. They should also include an overall description of the evolution of the relevant features of economic policy during the period, including those which it may not be possible to relate in a simple or clear-cut way to changes in available statistical aggregates. Moreover, in order to bring out more clearly the effects of different phenomena on the development process, analysts should use as necessary available ad hoc information concerning such matters as the growth of, and prospects for, key sectors in the fields of manufacturing, mining, and primary production. Other less systematic information which may prove useful for both the macroeconomic and microeconomic parts of the studies will include not only that obtained in interviews of officials of ministries, central banks and multilateral agencies but also that gleaned from surveys of businessmen's plans.

The sequel contains a more detailed description of the kinds of information which the studies should contain and of methods which should help to organize relevant data in such a way as to facilitate comparison of the main points noted in the different studies. These methods include an accounting framework for analyzing various aspects of the country's deficit on current account and a simple forecasting model for investigating, in an internally consistent manner, the interrelationships of the country's external sector and some key domestic macroeconomic variables under possible alternative scenarios of the future. The experiences of the countries covered in the studies will have some unique features. Moreover, both the amount and the types of relevant information available will vary from country to country. Thus the guidelines which follow will have to be adapted by the analysts to the particular problems they have to confront in their studies. Nevertheless, these guidelines should help to give common elements to the studies' formats, thus facilitating the tasks of both analysis and prescription in the eventual overall report.

## 2. External shocks and the policy response

This section is concerned primarily with suggestions as to ways of organizing a discussion of the evolution of the country's deficit on current account and of its policy response. It sets out an accounting framework which can be used to analyze many aspects of both these topics. It also enumerates the different measures and areas of economic policy which the analysts may need to consider.

### 2.1 The purpose of the accounting framework

The accounting framework is designed to help organize a discussion

of the following questions:

1. Which were the most important factors underlying the evolution of the current-account deficit of the country in the 10-to-15 year period up to the end of 1983?
2. How was this deficit financed, when due account is taken of such phenomena as capital flight and arrears?
3. What were the consequences of this mode of financing for the accumulation of external debt and the behaviour of foreign-exchange reserves?
4. How much better off would the country be now if as a counterfactual exercise it is assumed that there had been no adverse external shocks in the 1979-1982 period?
5. How much balance-of-payments adjustment has the country already achieved, and what were the costs of these adjustments in the 1980- -1983 period?
6. What were the respective roles of policy measures and various other factors in the achievement of this balance-of-payments adjustment?

## 2.2 The specification of the accounting framework

An identity is proposed for decomposing the current-account deficit of the country in such a way that

- (a) the role of the pressure of domestic demand on capacity can be ascertained empirically, fixed investment being analyzed separately from other components of domestic demand both because of its effect on future productive capacity and because of its presumed higher import intensity;
- (b) the behaviour of exports can be analyzed;
- (c) the impact of both changes in international interest rates and past debt accumulation can be visualized;
- (d) the impact of changes in import coefficients (both for current production and for fixed investment) can be evaluated; and



(e) the effects of variations in the terms of trade can be measured.

The derivation of the decomposition formula is described in appendix A.1. Although the details are cumbersome, the underlying analytical ideas are simple. Firstly, the current-account deficit is expressed by adding net unrequited transfers, workers' remittances, and factor services to the difference between imports and exports of goods and non-factor services. Imports are then subdivided into two groups, capital-goods imports and current imports. The first group is associated with fixed investment, and the other with domestic output. The variables are then divided through by the value of potential output in order to make possible a fuller analysis of the factors bearing on the evolution of the deficit. The final expression is as follows:

$$\begin{aligned}
 D_t/Y^*_t = & j_{kt} (P_{kt}/P_{Yt}) I_t/Z^*_t + j_{yt} (P_{jt}/P_{Yt}) Z_t/Z^*_t \\
 & + r_t (F_{t-1}/Y^*_t) - (P_{xt}/P_{Yt}) (X_t/W_t) (W_t/Z^*_t) \\
 & - R_t/Y^*_t - T_t/Y^*_t
 \end{aligned} \tag{1}$$

where:

- D = Current-account deficit in current prices.
- $Y^*$  = Potential domestic output in current prices.
- $Z^*$  = Potential domestic output in 1975 prices.
- Z = Actual domestic output in 1975 dollars;
- I = Fixed investment in 1975 prices;
- F = Net foreign liabilities at the end of the year;
- X = Exports of goods and non-factor services in 1975 prices;
- W = World exports in 1975 prices;
- R = Net workers, remittances from abroad, in current prices;
- T = Net unrequited transfers from abroad, in current prices;
- $j_k$  = Ratio of capital goods imports to fixed investment in 1975 prices;
- $P_k$  = Dollar price index of capital goods imports with 1975 = 1.0;
- $P_Y$  = Implicit price deflator of GDP (with 1975 = 1.0) divided by the dollars/domestic currency exchange rate (with 1975 = 1.0);
- $j_y$  = Ratio of non-capital-goods imports in 1975 dollars to domestic output in 1975 dollars;
- $P_j$  = Price index of non-capital goods imports with 1975 = 1.0.

$r$  = Dollar rate of return on net foreign liabilities, expressed as a ratio of factor payments abroad in dollars in the current year to the dollar value of net foreign liabilities at the end of the previous year;

$P_x$  = Price index of exports with 1975 = 1.0;

$t$  = Calendar year.

The following comments are in order. Firstly, it should be emphasized again that equation (1) is only an organizing device, which it is hoped will ensure some degree of consistency and comparability among the different country studies. The analyst may well wish to break down some of the variables on the right-hand side into their constituent parts for more detailed analysis (for example, in order to consider traditional exports separately from non-traditional exports, or to subdivide the stock of foreign capital into official loans, medium and long-term private loans, short-term loans, and foreign investment).

Secondly, the nominal variables in equation (1) can be expressed either in local currency (as they appear in the national accounts) or in United States dollars (as they normally appear in the balance-of-payments statistics). Either way, there is bound to be an exchange rate conversion, to express national income concepts in dollar terms, or to translate balance-of-payments variables into local currency. Measurement biases will inevitably arise (for example, in estimation of the current account deficit ratio to potential GDP), as a consequence of eventual abrupt changes in the external parity of the domestic currency. The analyst should be aware of this difficulty, and be prepared to deal with it as the need arises. The ideal denominator in (1), from this point of view, would be the "equilibrium" dollar value of potential GDP, which requires the calculation of an "equilibrium" exchange rate. This is an elusive concept, which perhaps should be applied only when serious interpretative distortions would be caused by the use of observed market exchange rates. In this case, a parity real exchange rate series could be computed, starting from some base year when "equilibrium" supposedly prevailed. This naturally leaves unattended the problem of estimating the effect of terms of trade changes on the "equilibrium" rate.

### 2.3 The use of the accounting framework to analyze the effects of economic policy and other factors

The accounting framework can be used to explain the determinants of the major ratios on the right-hand side of equation (1). Such an explanation may comprise the effects of both economic policy and other factors on the major constituent parts of the current account. In particular it should be possible to indicate the impact of fiscal and monetary policy on the evolution of the external deficit. It may also be possible to explore some of the implications for the country's external-payments position of the investment strategy being followed and

of the associated policies for export promotion and import substitution. However, it should be emphasized that observed movements of the variables on the right-hand side of equation (1) are likely to reflect several influences other than policy measures (such as the impact of shortages of foreign exchange on the availability of various categories of imports). For example, the observed behaviour of  $j_y$  and  $j_k$  may reflect the effects of various factors such as (i) changes in the sectoral composition of output or investment (where there are differences in sectoral import coefficients), (ii) the maturation of import-substitution activities, (iii) changes in real exchange rates or other causes underlying domestic price movements, which may affect the distribution of domestic demand between imported and domestic goods, (iv) the changing pressure of aggregate demand in relation to available domestic capacity and the consequent changes in import requirements, (v) the effects of the weather or natural catastrophes, and (vi) reductions of imports of consumer goods, inputs, spares, etc., resulting from a lack of foreign exchange.

An adequate evaluation of the underlying causes of the movements in  $D/Y^*$  may require a further disaggregation of the import terms on the right-hand side of equation (1) (distinguishing e.g. between oil, food, and other current imports). It is for the analyst to judge what is the optimal degree of disaggregation, taking into consideration the amount of detail required to illuminate the more important aspects of the country's macroeconomic experience during the 1970s and early 1980s.

For some countries it may be especially difficult to estimate  $Z^*$ . Some suggestions as to methods which may be employed for this purpose are provided in appendix A.2. 1/

#### 2.4 Some aspects of the policy response

It will probably not be possible to provide a sufficiently complete discussion of relevant aspects of the country's policy response solely in the context of movements of the variables included in the accounting framework. As already noted, these movements reflect not merely the impact of policy measures but also that of many other factors in such a way that the respective contribution of each is often difficult to identify. There are also other reasons for including an autonomous account of economic policy as an integral part of the country studies. For example, the greater difficulties in formulating and implementing

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1/ An alternative decomposition of the current account deficit, which does not require the estimation of potential output, is presented as an appendix to the synthesis paper of G. Helleiner.

economic policy experienced by governments of developing countries as a result of the deterioration in the external environment should be mentioned in a complete discussion of the adjustment process in such countries during recent years.

A second consideration of great importance in this context is that the making of economic policy has sectoral as well as macroeconomic dimensions. These sectoral dimensions are often difficult to deal with by further disaggregation of the accounting framework. Yet it is a fact that the impact of external economic pressures has often been particularly severe at the level of particular sectors, especially those producing commodities. Moreover, cuts in public expenditure have widely resulted in reductions of investment and of subsidies provided under industrial policies (often intended to promote infant-industries), in many cases seriously impairing both current positions and future prospects in sectors where public enterprises predominate or the government's role as a provider of funds is crucial. Much of the sector analysis undertaken for the country studies is likely to be somewhat ad hoc or qualitative. Nevertheless, such analysis will often be particularly valuable in that it directs attention to certain aspects of recent experience, especially the slow-down of investment in developing countries mentioned in the introductory passages above.

The account of economic policy should focus on measures designed to redress the balance of payments. Some of these are no doubt of a relatively short-run nature, concerned primarily with the balance between demand and supply. Others have longer-run objectives, including inter alia the alteration of various key structural parameters of the economy. No classification of economic policy measures under major headings is altogether satisfactory owing to the possible use of many of them for attaining various different objectives. Nevertheless, the following checklist of aspects of economic policy likely to be relevant to the management of countries' external payments may prove useful: (1) fiscal policy, (2) mobilization of domestic resources, (3) exchange rates, (4) monetary policy, (5) credit policy, (6) incomes policy, (7) export promotion and diversification, (8) import substitution, (9) import controls, (10) price policies and subsidies, (11) sectoral policies, (12) external financing and the management of foreign debt.

## 2.5 Deficit financing and external debt

The observed movements in the foreign-exchange reserves of some countries in recent years reflect not only the effects of changes in deficits on current account but also capital flight and the accumulation of arrears. It may be possible to measure the magnitude of capital flight as the sum of short-term gross capital outflows and the item denoting errors and omissions in balance-of-payments statistics. Some idea can usually be obtained of the size of arrears from information published in the IMF's annual report on exchange restrictions and other sources, including official ones and the financial press.



External financing is provided either by direct investment or by additions to external debt. The sources of the latter may be either official or private, and the additional debt may be short-term, medium-term or long-term. Analysts should make an effort to present the evolution of the total value and the decomposition of the external debt in a form that is compatible with the statistics for the capital account of the balance of payments. To guarantee comparability with the accounting framework of subsection 2.1, the relevant variables should also be presented as ratios to the dollar value of potential output.

## 2.6 Analyzing the effects of external shocks through counterfactual scenarios

In addition to the examination of the evolution of the country's external -payments position and its policy response along the lines suggested in sub- sections 2.1 - 2.5 it may also be useful to carry out the following exercises for the period 1979-1983. These exercises are intended to illuminate the relationships between external shocks and the adjustment policies adopted by the country.

Suppose that 1978 is taken as the base period (although a particular analyst may decide that this year is inappropriate to the case of the country concerned and that another period must be chosen). Then consider the hypothetical evolution of the current account and of the accumulation of foreign debt in 1979-1983, on the assumptions that (i) the terms of trade, (ii) international interest rates, and (iii) the ratio of the relevant international trade index to potential domestic output (i.e.  $W/Z^*$  in equation (1)) remain constant at the value in 1978.

Such an analysis would be incomplete, since it assumes that the values of the other variables on the right-hand side of equation (1), except for the terms of trade, interest rates, and world trade, would be the same as those observed for 1979-1983. Clearly some of these variables in fact also changed in response to external shocks, and thus their assumed constancy is likely to exaggerate their impact on the external situation. However, the analysis does indicate the extent of the additional adjustment or financing (or both) required by the shocks.

In this context it is desirable to distinguish as far as possible between positive and negative policy responses. An example of a negative policy response would be a contractionary fiscal and monetary policy, which simply reduces domestic absorption but does nothing to ensure that the slack domestic capacity thus created is deployed either to expand exports or to reduce competitive imports. Another example of a negative policy response is one that adversely affects income distribution (say, by reducing real wages) without causing either exports or import-substituting activities to expand. These negative policy responses should improve the balance of payments, since imports would contract in consequence of the reduction of government or private-sector demand (in the first case) and of workers' demand (in the second). However, the costs in terms of forgone output, additional unemployment, and worsened income distribution should be pointed out.

These remarks should not be construed to mean that fiscal and monetary austerity or a devaluation of the real exchange rate are always negative measures. If the economy is overheated, there may be no way of expanding net exports except by contracting domestic absorption. Moreover production of tradeable goods may be stalled not for lack of demand but because of an overvalued real exchange rate. In this case a real devaluation would indeed expand both output and employment. Income distribution may be hurt as a consequence of the austerity measures or the real devaluation. However, the analyst may still want to classify such measures as positive, provided that no realistic alternatives were available in the short run.

A necessary condition for classifying a policy measure as positive is that it has the effect of increasing the  $X/W$  in equation (1), reducing the ratios involving imports in the same equation, or changing the composition of fixed investment towards activities which generate earnings of foreign exchange.

There follows a suggested decomposition of the current-account changes, which takes into account both the shocks and the policy responses. 2/ Consider the difference between the deficit ratio in year  $t$  (where  $t$  is successively equal to 1979, 1980, 1981 and 1982) and its value for 1978. Then, we can write:

$$\begin{aligned} d(D_t/Y^*_t) = & [j_{ko}(I_o/Z^*_o)d(P_{kt}/P_{yt}) + \\ & j_{yo}(Z_o/Z^*_o)d(P_{jt}/P_{yt}) - (X_o/Z^*_o)d(P_{xt}/P_{yt})] + \\ & [(F_{-1}/Y^*_o)dr_t] - [(P_{xo}/P_{yo})(X_o/W_o)d(W_t/Z^*_t)] + \\ & [(P_{ko}/P_{yo})(I_o/Z^*_o)dj_{kt} + (P_{jo}/P_{yo})(Z_o/Z^*_o)dj_{yt} \\ & - (P_{xo}/P_{yo})(W_o/Z^*_o)d(X_t/W_t)] + [j_{ko}(P_{ko}/P_{yo}) \cdot \\ & d(I_t/Z^*_y) + j_{yo}(P_{jo}/P_{yo})d(Z_t/Z^*_t)] + [r_0d(F_{t-1}/Y^*_t)] \\ & - [d(R_t/Y^*_t) + d(T_t/Y^*_t)] + 2\text{nd- and } 3\text{rd-order terms} \quad (2) \end{aligned}$$

where the subscript  $o$  indicates the value of the subscripted variable

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2/ For similar decomposition exercises, see Balassa, B., "Policy responses to external shocks in Sub-Saharan countries", Journal of Policy Modelling, 5(1), March 1983: 75-106, and Mitra, P.K., "Accounting for adjustment in selected semi-industrial countries", World Bank, mimeo, 1983.

for a base year, and d the change of the variable between 1978 and year t (t = 1979, 1980, 1981 or 1982). 3/

The bracketed expression on the right-hand side of equation (2) can be labelled as follows according to the previous discussion: change in deficit ratio = [terms-of-trade shock] + [interest-rate shock] + [world-recession shock] + [positive policy response] + [negative policy response] + [effect of change of accumulated debt] - [impact of other external variables] + 2nd and 3rd-order terms.

The exercises above take account only of adverse shocks affecting the current account. However, during the latter part of the period the access of developing countries to international financial markets became more difficult and capital flight from some of them gathered momentum. For the countries affected by these phenomena an increasing proportion of deficits on current account had to be financed by reserve losses, which eventually forced the adoption of contractionary policies. The analyst may decide that the impact of capital flight and impaired access to international financial markets should also be explored by means of an exercise analogous to that incorporated in equation (2).

### 3. Forecasting model

As a consequence of the foreign-exchange difficulties of the last few years many developing countries have undertaken adjustment programmes which are causing significant drops in their per capita incomes. Recent simulation studies, notably those of Cline and of Leven and Roberts, 4/ find that the current debt crisis in developing countries will soon be over. According to these projections, a new phase of export-led growth can be established in these countries as long as domestic austerity is preserved and the growth rates of the countries members of the OECD as a group do not fall below 3 per cent per annum in the near future.

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3/ In the decomposition exercises reported in the synthesis paper by G. Helleiner, the base year for the weights is an average of 1978 and the current year. This was chosen in preference to either 1978 or current year weights in order to minimize the value of the 2nd and 3rd order terms.

4/ Cline, W., International Debt and the Stability of the World Economy (Washington, D.C.: Institute of International Economics, Policy Analyses in International Economics, vol.4, September 1983, distributed by MIT Press), and Leven R. and D. L. Roberts, "Latin America's Prospects for Recovery", Quarterly Review of the Federal Reserve Bank of New York, 8(3), Autumn 1983.

A very short-run view of the consequences of current foreign-exchange difficulties for the future growth prospects of developing countries seems to underlie such projections. Currently fixed investment is running at very low levels in these countries as a result of the sharp adjustment which they are experiencing. Hence the export capacity may not be there when OECD growth resumes, or sharp consumption cuts in some cases may need to be made in the future to seize these new export opportunities.

Raising the depressed levels of investment in developing countries will require additional external financing. Indeed, under current conditions additional financing which tided such countries over their short-run balance-of-payments disequilibrium would have a very high return. It would lessen current foreign-exchange constraints, while allowing the expansion of domestic capacity to produce tradeables. This would guarantee that the debt could be serviced in the future, when the expected resumption of OECD growth began to provide the necessary export markets.

The purpose of the simulation model that follows is to investigate the dynamics of the balance-of-payments adjustment processes in developing countries. In the first place it characterizes the extent to which the current economic prospects of developing countries are constrained by foreign-exchange availability. Secondly, it investigates the seriousness of the future shortages of capacity and savings that may emerge under current adjustment programmes. Thirdly, it simulates the consequences of alternative financing mechanisms for the current payments difficulties of these countries.

The model assumes that the economy is constrained by the availability of foreign exchange at least in the initial years of the forecasting period. This means that the size of both exports and the current-account deficit is given exogenously. The model then generates joint predictions for the paths of imports, domestic output, fixed investment, domestic absorption and consumption, which are conditional on the behaviour of exports, the terms of trade, foreign capital income, current-account deficits, and domestic savings rates. The current-account deficit is the difference between the capital-account surplus and the accumulation of international reserves. Hence one needs to specify exogenously not only the gross capital inflows minus amortization and other flows of funds abroad but also a rule for the accumulation of foreign reserves.

Feedback rules ensure that the trajectories for the relevant variables are consistent both with the overall capacity being built and with a more specific capacity to generate exports.

The model is as follows. The dollar value of imports ( $M$ ) is equal to the sum of the dollar values of current and capital-goods imports, the real values of which are related to the levels of real output and real gross fixed investment respectively:



$$M_t = P_{jt}J_{yt} + P_{kt}J_{kt} \quad (3)$$

$$J_{hy} = j_y Z_t + \text{constant} \quad (4)$$

$$J_{kt} = j_k I_t + \text{constant} \quad (5)$$

The constants in equations (4) and (5) [and in (9) to follow] are designed to help calibrate the model for the base-year of the projections, without the need to change the values of the "structural" coefficients  $j_y$ ,  $j_k$ , and  $s$ .

Omitting transfers for simplicity, the dollar value of the current-account deficit is equal to the dollar value of imports plus net factor services (V) minus exports ( $P_x X$ ) and workers' remittances (R) :

$$D_t = M_t + V_t - P_x X_t - R_t \quad (6)$$

The current-account deficit is also equal to the dollar value of domestic absorption ( $P_a A$ ) minus the dollar value of national income:

$$D_t = P_{at}A_t - P_{yt}Z_t + V_t - R_t \quad (7)$$

The dollar value of domestic absorption is equal to the sum of the dollar values of gross fixed investment ( $P_i I$ ) and of other components of domestic absorption which will be denoted as ( $P_c C$ ):

$$P_{at}A_t = P_{it}I_t + P_{ct}C_t \quad (8)$$

The real value of consumption is assumed to depend on real national income as follows:

$$C_t = (1 - s) ((P_{yt}/P_{ct})Z_t - V_t/P_{ct} + R_t/P_{ct}) + \text{constant} \quad (9)$$

The following price definitions are adopted to compute the dollar values of income, consumption and gross fixed investment:

$$P_{yt} = P_{xt} \quad (10)$$

$$P_{ct} = P_{jt}^{1-b} P_{yt}^b \quad \text{with } b = P_{jo} J_{yo} / (P_{jo} J_{yo} + P_{yo} Z_o) \quad (11)$$

$$P_{it} = p_{kt}^g p_{yt}^{1-g} \quad \text{with } g = p_{ko} J_{ko} / p_{io} I_o \quad (12)$$

Equation (10) sets the dollar value of the implicit GDP price deflator equal to the dollar price of exports. According to (11), the dollar price of consumption is a geometrically-weighted average of the dollar prices of current imports and domestic product, where the weights are given by the share of current imports in total supply in a base year

(which could be an average for the 1972-1982 period). Similarly, (12) defines the dollar price of investment as a weighted average of the dollar prices of imported capital goods and of domestic product, where the weights are given by the share of capital-goods imports in gross fixed investment in a base year.

For given values of the constants in the import and consumption equations, and of  $D_t$ ,  $V_t$ ,  $R_t$ ,  $X_t$ ,  $P_{jt}$ ,  $P_{kt}$ ,  $P_{xt}$ ,  $s$ ,  $j_y$ , and

$j_k$ , these ten equations yield the current values of  $M_t$ ,  $J_{yt}$ ,  $J_{kt}$ ,

$Z_t$ ,  $P_{atA_t}$ ,  $I_t$ ,  $C_t$ ,  $P_{yt}$ ,  $P_{ct}$ , and  $P_{it}$ .

Foreign capital income can be written as a multiplicative function of the current rate of return ( $r$ ) and lagged values of the stock of foreign capital ( $F_{-1}$ ):

$$V_t = r_t F_{t-1} \quad (13)$$

The following rule applies to the accumulation of foreign-denominated liabilities:

$$F_{t-1} = F_{t-2} + D_{t-1} \quad (14)$$

Thus  $V_t$  will be endogenously generated, once the initial value of the foreign capital stock and the projected values of the rates of return are fed into the programme.

Consider now the constraints other than those on foreign-exchange availability which the economy needs to observe. First, gross fixed investment cannot be negative. Hence

$$I_t \geq 0 \quad (15)$$

Second, domestic output cannot surpass available capacity:

$$Z_t \leq Z^*_t \quad (16)$$

where

$$Z^*_t = aK_t \quad (17)$$

and where  $K$  is the capital stock at the beginning of the period,  $a$  being the output/capital ratio. The capital stock is generated according to

$$K_t = (1-d)K_{t-1} + I_{t-1} \quad (18)$$

where  $d$  is the depreciation rate. Since figures for the capital stock may be hard to obtain, (17) and (18) can alternatively be expressed as

$$Z^*_t = (1-d)Z^*_{t-1} + aI_{t-1} \quad (19)$$

Provided that depreciation rates and estimates of the incremental capital/output ratio are available, the series for potential output can be generated from equation (19), once an initial value for this variable has been fed into the programme. Equation (19) implies that gross fixed investment should be no less than  $(d/a)Z^*$  to prevent the economy from shrinking. This restriction is not built into the model because such shrinkage may be occurring under current austerity programmes in some developing countries.

Third, actual exports cannot surpass the value of potential exports:

$$X_t - X^*_t \quad (20)$$

where  $X^*$  is given by:

$$X^*_t = eZ^*_t \quad (21).$$

$e$ , the potential export ratio, is derived either from the past experience of the country, or from an assessment of the changes currently being made in investment composition in favour of export activities. Similar methods can be used to estimate the value of  $j_k$  and  $j_y$  in (5) and (6).

The programme continuously updates the values of  $Z^*$  and  $X^*$ , according to (19) and (21), thus checking if restrictions (15), (16) and (20) are being observed by the equation system (3) - (14). If (20) is violated, this means that exports are no longer constrained by foreign demand but by  $X^*$ , and the solution is recomputed. If (16) is violated, this means that the economy ceases to be foreign-exchange constrained and starts being constrained by domestic capacity,  $Z^*$ . In this case, we set  $Z$  equal to  $Z^*$  and abandon the value of exports given by external demand.  $X$  is then endogenously determined by the balance between total supply and domestic absorption in accordance with the equations (3) - (14) with  $Z = Z^*$ . Finally, if a negative value for gross fixed investment results from the operation of the model,  $I$  should be set equal to zero to comply with restriction (15). The savings rate would then be endogenously determined by the system (3) - (14) 5/

It may well be of interest to check the employment implications of the model. This could be done with the help of an equation such as

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5/ The above is a heuristic description. For the actual workings of the computer model, see Luiz Avila, "Forecasting Model - Manual", UNCTAD/New York, mimeo, 1984. The computer programme includes additional facilities, such as a flexible savings rate, which are not explored here.

$$N = \sum_t \frac{h}{t} \quad (22)$$

where  $N$  is the appropriately normalized employment level and  $h$  is the elasticity of employment with respect to output, which can be estimated from available statistics.

It is obviously desirable that simulations with this model should be based on one or more sets of assumptions about the future evolution of the external economic environment. These should be designed to enhance the plausibility of the forecasting exercise and to ensure consistency with respect to the simulations undertaken for the different countries. The UNCTAD secretariat will provide assistance with respect to the choice of such assumptions.

It should be emphasized that the model set out in this section is intended to make it possible for the country analysts to undertake a comparable set of simple forecasting exercises. Individual analysts may feel that a more detailed treatment of certain variables or parts of the model would also be worth undertaking for their own countries.

### Appendix

This appendix deals with two questions: (i) the derivation of the decomposition of the current-account deficit in equation (1); and (ii) the definition and measurement of potential output.

#### A.1 Derivation of equation (1)

The following proceeds on the assumption that the analyst has chosen to base his study on the balance-of-payments statistics, hence converting into dollars the variables originally appearing in domestic currency in the national accounts. The appendix to G. Helleiner's synthesis paper discusses a formulation which starts from the national accounts in domestic currency units. In that case, an appropriate exchange rate is used to convert into domestic currency units those balance-of-payments variables which originally appear in the statistics in dollar units.

Consider the following simplified definition of the dollar value of the current account deficit for year  $t$ :

$$D_t = M_{kt} + M_{jt} + V_t - E_t - R_t - T_t \quad (A1)$$

where

$M_{kt}$  = Dollar value of capital-goods imports (CIF);



$M_{jt}$  = Dollar value of non-capital-goods imports, including imports of non-factor services not accounted for in  $M_{kt}$ ;

$V_t$  = Dollar value of net payments for factor services (excluding workers' remittances);

$E_t$  = Dollar value of exports of goods and non-factor services;

$R_t$  = Dollar value of net workers' remittances; and

$T_t$  = Net unrequited transfers from abroad, in dollars.

Define the value of imports in 1975 dollars as follows:

$$J_{kt} = M_{kt}/P_{kt} \quad (A2)$$

$$J_{yt} = M_{yt}/P_{jt} \quad (A3)$$

where:

$J_{kt}$  = Capital goods imports in 1975 dollars;

$J_{yt}$  = Non-capital goods imports in 1975 dollars;

$P_{kt}$  = Dollar price index of capital-goods imports with 1975 = 1.0; and

$P_{jt}$  = Dollar price index of non-capital-goods imports with 1975 = 1.0.

Define the import coefficients as follows:

$$j_{kt} = J_{kt}/I_t \quad (A4)$$

$$j_{yt} = J_{yt}/Z_t \quad (A5)$$

where

$I_t$  = Gross fixed investment in 1975 dollars, and

$Z_t$  = GDP at market prices in 1975 dollars.

Authors may want to start from the gross fixed investment and domestic output series in 1975 domestic currency units (pesos). The conversion of 1975 pesos into 1975 dollars could be made on the basis of the exchange rate that is used in the national accounts. At factor costs, this should be equal to the average exchange rate for the year, appearing in the balance-of-payments statistics.

Define the value of exports in 1975 dollars as

$$E_t/P_{xt} = X_t = (X_t/W_t)W_t \quad (A6)$$

where

$P_{xt}$  = Dollar price index of exports with 1975 = 1.0,

$W_t$  = World exports in constant 1975 dollars, and,

hence,  $X_t/W_t$  is the country's share in world exports in 1975 dollars.

Define the rate of return on foreign liabilities as:

$$r_t = V_t/F_{t-1} \quad (A7)$$

where

$F_{t-1}$  = Dollar value of net foreign liabilities at the end of the previous year.

If available statistics on the stock of foreign direct investment are not reliable, authors may want to subdivide  $V$  into interest payments on the one hand and profits and other foreign capital income on the other. In this case (A7) would refer only to interest outflows and the stock of foreign debt, while profit remittances, etc., would be treated as a separate component in the exercise.

Using (A2)-(A7), (A1) can be rewritten as follows:

$$D_t = P_{kt}j_{kt}I_t + P_{jt}j_{yt}Z_t + r_tF_{t-1} - P_{xt}(X_t/W_t)W_t - R_t - T_t \quad (A8)$$

Define the value of potential output in current dollars as:

$$Y^*_t = P_{yt}Z^*_t \quad (A9)$$

where

$Z^*_t$  = potential output in 1975 dollars (see section A.2 below),  
and

$P_{yt}$  = implicit price deflator of GDP (with 1975 = 1.0) divided by the peso/dollar exchange rate (with 1975 = 1.0)

The calculation of the peso/dollar exchange rate for each year  $t$  should follow the procedure previously described for the calculation of this rate in 1975. But authors should also compute the value of the parity exchange rate, to check on possible measurement errors being introduced by an overvalued or undervalued market exchange rate. If differences are significant, authors may want to replace market exchange

rate conversions by appropriately defined parity exchange rate conversions. Equation (1) in the text is obtained by dividing (A8) by (A9).

## A.2 The measurement of potential output

As noted in subsection 2.3, it is frequently difficult to construct reliable estimates of potential output ( $Z^*_t$ ). Even in the case of the developed market-economy countries various different methods are employed for this purpose, and none of them <sup>6/</sup> are beyond criticism. In most developing countries where agriculture is responsible for a large share of national production, estimates are further complicated by the effects of variations in the weather.

The definition proposed in the text for  $Z^*$  is given in equation (17) of section 3.  $Z^*$  is assumed to be proportional to the economy's reproducible wealth. The coefficient of proportionality,  $a$ , together with the depreciation rate,  $d$ , should ideally be estimated from a regression equation of the form of equation (19) in section 3. However, actual output would have to be substituted for potential output in this estimation, some ad hoc allowance (perhaps involving dummy variables) being made for years in which the rate of capacity utilization is known to have been low. If estimates of the relevant incremental capital/output ratio and depreciation rates are independently available,  $Z^*_t$  can be estimated from equation (19) so long as the analyst can provide a figure for this variable in the initial year of the series.

However, the analyst may decide that it is more appropriate to have recourse to simpler alternatives, which might include the following: (i) fitting a time trend to the actual output series and then raising the resulting line in such a way that it passes through the value of output in some year for which the analyst considers that available capacity was fully utilized, or (ii) joining the cyclical peaks of the actual output series, calling the points of the connecting lines potential output.

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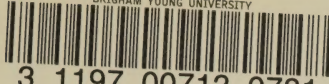
<sup>6/</sup> Analysts may wish to consult the survey of the methods used in various developed market-economy countries to estimate potential manufacturing output in Christiano, L.J., "A survey of measures of capacity utilization", IMF Staff Papers, March 1981.







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